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Supreme Court, U.S.
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No. _____

In the

Supreme Court of the United States

October Term, 1988

NORTHWESTERN BELL TELEPHONE COMPANY,
Petitioner,

v.

MINNESOTA PUBLIC UTILITIES COMMISSION,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE MINNESOTA COURT OF APPEALS

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QUESTIONS PRESENTED

1. Did a federal court order, entered pursuant to the Tunney Act, 15 U.S.C. § 16(e), that required Northwestern Bell's divestiture with a capital structure consisting of forty-five percent debt preempt the Minnesota Public Utilities Commission from imputing to petitioner Northwestern Bell Telephone Company a hypothetical capital structure consisting of 50.1 percent debt?

2. Was Northwestern Bell deprived of its constitutional right to procedural due process?

3. Did the State of Minnesota take Northwestern Bell's property without just compensation?

LIST OF PARTIES AND RULE 28.1 LIST

The parties to the proceedings below were Petitioner Northwestern Bell Telephone Company and Respondent Minnesota Public Utilities Commission. Other parties appearing and participating as Respondents in the Minnesota Court of Appeals were the Attorney General for the State of Minnesota, the Minnesota Department of Public Service and the Minnesota Public Interest Research Group.

Northwestern Bell Telephone Company, an Iowa corporation, is a wholly owned subsidiary of U S West Communications, Inc., which is a wholly owned subsidiary of U S West, Inc.

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MINNESOTA PUBLIC UTILITIES COMMISSION,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE MINNESOTA COURT OF APPEALS

The Petitioner Northwestern Bell Telephone Company respectfully prays that a Writ of Certiorari issue to review the order of the Minnesota Court of Appeals dated December 29, 1987, which affirmed final Orders of the Minnesota Public Utilities Commission dated April 2 and 3, 1987, re-opening and re-deciding a three-year-old final telephone rate proceeding.

OPINIONS BELOW

The opinion of the Minnesota Court of Appeals is reprinted at 417 N.W.2d 274, *infra* at p. A-181. The Minnesota Supreme Court denied review of the decision of the Court of Appeals by order dated March 18, 1988, and denied rehearing by order dated April 4, 1988. Neither those orders nor the orders of the Minnesota Public Utilities Commission dated April 2 and 3, 1987, have been reported. They are reprinted in the Appendix hereto at pp. A-203, A-215, A-111, and A-129 *infra*, respectively.

JURISDICTION

The jurisdiction of this Court to review by writ of certiorari the action of the Minnesota Court of Appeals is invoked under 28 U.S.C. § 1257(3).

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

United States Constitution, Clause 2:

"This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."

United States Constitution, Fifth Amendment:

"... nor shall private property be taken for public use, without just compensation ..."

United States Constitution, Fourteenth Amendment, Section 1:

"No State shall make or enforce any law which shall abridge the privileges and immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law ..."

Tunney Act, 15 U.S.C. § 16(e):

"Before entering any consent judgment proposed by the United States under this section, the court shall determine that the entry of such judgment is in the public interest. For the purpose of such determination, the court may consider —

...

(2) the impact of entry of such judgment upon the public generally and individuals alleging specific injury from the violations set forth in the complaint including consideration of the public benefit, if any, to be derived from a determination of issues at trial."

STATEMENT OF THE CASE

This Petition for Certiorari seeks review of the affirmance of two Minnesota Public Utilities Commission ("Commission") Orders that re-opened a three-year-old final telephone rate case and prospectively lowered the annual revenue of Northwestern Bell Telephone Company ("Northwestern Bell") by over twelve million dollars. Ten million dollars of this revenue reduction resulted from the Commission's change of its 1984 position on a single issue—the appropriateness of Northwestern Bell's debt-equity ratio—which is directly contrary to federal court order.

This case has a complex procedural history, which commenced when Northwestern Bell filed a petition for a $109 million annual telephone rate increase on September 29, 1983. The rate case must, however, be addressed in the context of the then ongoing divestiture of Northwestern Bell from American Telephone & Telegraph Company ("AT&T").

1. Divestiture and the Debt Ratio Required by the Federal District Court.

Prior to 1983, Northwestern Bell and the other Bell operating companies, which at that time were still wholly owned subsidiaries of AT&T, provided a wide range of inter-related telecommunications products and services. At that time, the federal government's antitrust action against AT&T and certain affiliated companies was pending in the United States District Court for the District of Columbia. *See United States v. American Telephone & Telegraph Co.*, 552 F.Supp. 131 (D.D.C. 1982). The United States had, *inter alia*, alleged Sherman Act violations and sought the divestiture from AT&T of the Bell operating companies. Northwestern Bell was one of those Bell operating companies. In 1982, after years of litigation, and at the conclusion of the presentation of the Justice Department's and AT&T's cases in chief at trial, the parties agreed to a consent decree that provided for the divestiture of the Bell operating companies. The consent decree also set forth in detail structural changes containing restrictions designed to prevent the operating companies from discriminating against AT&T's competitors and to avoid a recurrence of the types of discriminating cross-subsidizations that

were alleged to be the basis of the lawsuit. *United States v. American Telephone & Telegraph Co., ibid.* at 142-143 (D.C.D.C. 1982).

The divestiture was to be accomplished by transfer of each of the Bell operating companies to one of seven new regional holding companies. The regional holding companies are separate from each other and from AT&T. Northwestern Bell and two other divested operating companies became subsidiaries of U S West, Inc., one of the regional holding companies. In satisfying the statutory obligations imposed by the Tunney Act, 15 U.S.C. § 16(e), to carefully scrutinize the proposed consent decree, the federal disctict court evaluated the debt-equity ratios to be assumed by the operating companies upon divestiture. *Id.* at 207-208, 226.

AT&T had stated its intention, to which the federal government agreed, to divest the operating companies, such as Northwestern Bell, with the debt component of its capital structure set at approximately forty-five percent. The Court required the proposed consent decree to be modified to incorporate a forty-five percent debt ratio, saying:

> The Court considers that its Tunney Act responsibilities require it to demand more of the parties on subjects which have significant public interest aspects than statements of intentions embodied in briefs or written comments, or made during oral argument. Accordingly, **the Court will require** that the proposed decree be modified to incorporate the forty-five percent debt ratio and the government's and AT&T's representations with regard to the quality of the Operating Company debt to the end that on the basis of such a modification, the Court will be in a position, if necessary, to insist that the statement of intention of the parties are actually implemented.

Id. at 207-208 (emphasis supplied).

In its order modifying the final judgment, the Court stated:

> At the time of the transfer of ownership provided for in section I(A) (4), the separated BOCs shall have debt ratios of approximately forty-five percent, (except for Pacific Telephone & Telegraph Company which shall

> have a debt ratio of approximately fifty percent), and the quality of the debt shall be representative of the average terms and conditions of the consolidated debt held by AT&T, its affiliates and the BOCs at that time. Upon application by a party or a BOC, the Court may grant an exception to this requirement.

Id. at 226 (emphasis supplied).

Divestiture became effective on January 1, 1984, at which time Northwestern Bell was divested with a debt ratio in compliance with the Court's Order.

2. The 1983-84 Rate Proceedings Before the Public Utilities Commission.

Pursuant to Minnesota's Administrative Procedure Act, Minn. Stat. § 14, contested case hearings on Northwestern Bell's September 1983 petition for a rate increase, known as the "Docket 600" proceedings, were conducted by an administrative law judge between January and April, 1984. The rates were to be set on a test year approach using 1983, **adjusted to reflect the effects of the 1984 divestiture of AT&T**, as the test year.

In the 1984 Docket 600 proceeding, Northwestern Bell argued to the Commission that the use of any hypothetical capital structure based on an equity ratio of less than fifty-five percent equity would be "patently unfair and unlawful, regardless of the evidence." Initial Brief, April 30, 1984, at pp. 159-160. Northwestern Bell also specifically argued that the federal court's order mandating divestiture of the Bell operating companies had required them to employ debt ratios of approximately forty-five percent and that the imposition of a capital structure using less than a fifty-five percent equity ratio would conflict with the order of the United States District Court.

By Orders dated July 27, 1984 and September 26, 1984, the Commission granted Northwestern Bell a rate increase of more than $57 million and established the design of rates Northwestern Bell must use in marketing its services to various classes of customers. These decisions complied with the debt ratio set by the federal district court's divestiture order.

During the course of the 1984 rate proceedings, Northwestern Bell filed with the Federal Communications Commission ("the FCC") a tariff related to its decision, newly permitted by the FCC, to enter

the market for customer premises telephone equipment. In that regard, Northwestern Bell was required to undergo a change in its corporate structure. An intervenor in the Docket 600 rate case, Evan Henry, argued to the Minnesota Public Utilities Commission that the rate case should be dismissed because of Northwestern Bell's failure to earlier advise the Commission of the restructuring. The Commission voted against dismissing the rate petition on June 8, 1984, but to consider the effect of the restructuring in the context of the rate proceeding on rehearing. This procedure was followed, and the Commission's July 27, 1984, Order was reduced by $363,000 because of the restructuring. See Order after Reconsideration and Rehearing dated september 26, 1298 *infra* at p. A-50

3. The Evan Henry Appeal From the 1984 Rate Order.

Intervenor Henry appealed the Commission's decision. The Minnesota Court of Appeals reversed the Order of the Commission, stating that the rate case should have been dismissed. *Henry v. Minnesota Public Utils. Comm'n*, 376 N.W.2d 226 (Minn. App. 1985). The Minnesota Supreme Court reversed the decision of the Court of Appeals and reinstated the decision of the Minnesota Public Utilities Commission of September 26, 1984. *Henry v. Minnesota Public Utils. Comm'n*, 392 N.W.2d 209 (Minn. 1986), *infra* at p. A-100. The Minnesota Supreme Court held that the Commission had decided the case in accordance with statutory procedure. It also held, based on its "careful review of the evidence in the record of this case and the 100 page order of the MPUC," that the rate increase "was supported by the record and was not arbitrary and capricious." *Id.* at 216.

4. The Department of Public Service Investigation and the Re-Opening of the 1984 Rate Order.

Prior to the Minnesota Supreme Court's decision in *Henry*, the Commission ordered an investigation in the Docket 600 rate case. This investigation arose out of newspaper reports of ex parte contacts between certain members of the Commission and representatives of certain utilities. The investigation was conducted by the Minnesota Department of Public Service, and not in accordance with statutory contested case hearing procedures.

The Department found no evidence that Northwestern Bell violated any statutes or regulations, but stated that Northwestern Bell's

contacts with certain Commissioners had tainted the decision-making process.

The Commission took administrative notice of the report of the Department of Public Service's investigation, which included affidavits and memoranda of interviews or telephone conversations conducted by the Department of Public Service, without affording Northwestern Bell prior notice or an opportunity to examine the individuals.

On July 9, 1986, the Minnesota Attorney General petitioned to reopen and reconsider the Docket 600 rate case. In November 1986, the Commission began deliberating whether it should take further action on the Docket 600 rate case. On April 2, 1987, without employing contested case hearing procedures, the Commission issued an order vacating the 1984 rate decision (affirmed by the Supreme Court on the merits in *Henry, supra*) and reopening that case for redeliberation and issuance of a new decision and order.

On April 3, 1987, the Commission issued its new decision after redeliberation of the 1983-84 rate case. *Infra* at p. A-129. The Commission decided to make its new 1987 decision based on the same 1983 test year data, adjusted for divestiture, that constituted the record before the Commission in the original rate case. *Infra* at pp. A-146—A-147. No new contested case hearings were held, nor was Northwest ern Bell given the opportunity to orally argue its case to the Commission, the majority of which were new Commissioners not involved in the 1984 deliberations.

By its 1987 redeliberation, the Commission reduced Northwestern Bell's rates for telephone service from $57,148,000 to $45,603,000, and revised the 1984 Order in several significant respects. The largest single component of the Commission's 1987 reduction of Northwestern Bell's 1984 rate increase resulted from the Commission's rejection of Northwestern Bell's actual capital structure, approved in 1984 and mandated for that time period by the federal court's divestiture order, and the imposition in its stead of a hypothetical capital structure with a much higher debt ratio. The Commission held that Northwestern Bell's capitalization of approximately forty-five percent debt and fifty-five percent shareholders' equity was not reasonable for the 1984 time period and imputed to Northwestern Bell a structure consisting of 50.1 percent debt and 49.9 percent

equity, reducing the rate base and, as a result, decreasing the previously approved rate increase by about $10 million per year.

In its Order after Redeliberation on April 3, 1987, the Minnesota Public Utilities Commission held that the capital structure set by the federal court's divestiture order did not preclude the Commission from imputing a different capital structure to Northwestern Bell, saying:

> The Company also suggests that, somehow, to allow less than a 55% equity ratio would either violate or materially interfere with the decision of the Federal Divestiture Court and the MFJ. Again, the Company attempts to use an Order of the Federal Court which was not entered for regulatory ratemaking purposes to, largely, avoid the issue.

Infra at p. A-169.

5. 1987 and 1988 Appellate Proceedings.

Northwestern Bell appealed the Commission's decisions to the Minnesota Court of Appeals, which affirmed in an opinion filed December 29, 1987. *See In The Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation*, 417 N.W.2d 274 (Minn. App. 1987), *infra* at p. 181.

Northwestern Bell pressed its due process arguments before the Minnesota Court of Appeals. The Court of Appeals rejected the claim that the denial of oral argument was a deprivation of the constitutionally guaranteed right to due process on the basis of the maxim, "He who seeks equity must do equity." *Infra* at pp. A-194—A-195 . Northwestern Bell also argued to the Court of Appeals that due process demanded that rates be fixed only after a formal hearing. Brief of Northwestern Bell Telephone Company to Court of Appeals, No. C7-87-1296, at pp. 47-49. The Court of Appeals opinion rejected this argument as well, stating that the Court had "considered Northwestern Bell's other arguments and find[s] them to be without merit." *Infra* at p. A-202.

Northwestern Bell sought discretionary review by the Minnesota Supreme Court of the decision of the Court of Appeals. The Petition for Review was denied on March 18, 1988. On April 4, 1988,

the Minnesota Supreme Court denied Northwestern Bell's timely Petition for Reconsideration of the denial of the Petition for Review. Northwestern Bell also raised the issues of federal preemption, due process and just compensation in its Petition for Reconsideration. *Infra* at pp. A-204 *et seq.* [1]

REASONS FOR GRANTING THE WRIT

I.

The federal court's order, entered pursuant to the Tunney Act, requiring Northwestern Bell's divestiture with a capital structure consisting of forty-five percent debt, preempted the Commission from imputing a different capital structure to Northwestern Bell.

Federal law preempts state law when state law actually conflicts with federal law, which arises when compliance with both federal and state law is impossible. *Michigan Canners & Freezers Ass'n, Inc. v. Agricultural Marketing and Bargaining Board,* 467 U.S. 461, 469 (1984).

The consent decree in the federal government's antitrust action was submitted to the federal district court before whom the anti-trust action was being tried for judicial consideration and approval. Pursuant to the Tunney Act, 15 U.S.C. § 16(e), the Court was required to carefully scrutinize the proposed consent decree. That statute provides that a proposal for a consent judgment submitted by the United States in an action brought under the anti-trust laws may not be entered by the Court without prior compliance with

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[1] Under Minnesota's Rules of Civil Appellate Procedure, a party may petition for rehearing of any order of the Minnesota Supreme Court. Rule 140.01, Minnesota Rules of Civil Appellate Procedure. In its petition for rehearing, the party must state any controlling statutes, decision or principle of law which, in petitioner's opinion, the Supreme Court has overlooked, failed to consider, misapplied or misconceived. *Id.* Because a Petition for Discretionary Review of a decision of the Court of Appeals is limited to a total of five double-spaced pages (including the statement of the case), *see* Minnesota Rule of Civil Appellate Procedure 117, subd. 3, the petition for rehearing, which has no length limitation, provides a meaningful method for raising these issues in some detail.

certain procedures, including a determination by the Court that the entry of the judgment is in the public interest. In making that determination, the Court is required to consider, among other things, the impact of the entry of such judgment upon the public generally, as well as the competitive impact of the judgment and the impact upon individuals alleging specific injury from the alleged violations. The Act allows the court to employ specific procedures including publication of a competitive impact statement by the Department of Justice and a sixty-day period for the receipt of public comments. Interpreting the Tunney Act's requirements, the Court stated: "It is clear that Congress wanted the courts to act as an independent check upon the terms of the decrees negotiated by the Department of Justice, and this Court will review the instant settlement in that spirit." *Ibid.* at 149 (footnote omitted).

The federal district court, in the exercise of its Tunney Act obligations, specifically added to the consent decree its order that the Bell Companies to be divested, **effective January 1, 1984,** with a debt to equity ratio of forty-five percent. *Ibid.* at 207-208, 226.

The federal district court's decision was not contingent upon state regulators' approval of the debt-equity ratio. One of the Bell operating companies, Pacific Telephone Company, had at the time of the modification of final judgment a substantially higher debt-equity ratio of approximately fifty-seven percent. The Court did not require AT&T to reduce Pacific Telephone's debt to forty-five percent, but accepted a reduction of debt to around fifty percent. The Court did not condition its order on approval by the State of California of the ratio. Thus, in assessing its obligations imposed by Congress in the Tunney Act, the federal district court imposed the requirement that Pacific Telephone & Telegraph use a fifty percent debt-equity ratio, notwithstanding the use by California regulators of a much higher debt-ration equity ratio. *Ibid.* at 208 n.320.

In 1983, several parties to the antitrust case attempted to convince the federal district court that the capital structure imposed by the Modification of Final Judgment was inequitable, in part because the various Bell companies operated under different tariffs. The Court disagreed, saying:

> Because the decree provides that the operating companies and AT&T will each receive a portion of the consol-

> idated debt and equity of the Bell System[59], it is reasonable for each of the post-divestiture entities also to receive a corresponding portion of the system's pre-divestiture business risks which encumber equity.
> ***
>
> [59]The decree provides that AT&T is to divest the operating companies with 45 percent debt ratios (55 percent equity) ...

United States v. Western Electric Co., Inc., 569 F. Supp. 1057, 1072 (D.D.C. 1983).

The Minnesota Public Utilities Commission, in its Order after Redeliberation in 1987, claimed to have used Northwestern Bell's results for test year 1983, **adjusted to reflect the effects of divestiture.** It, however, reversed its 1984 position on the appropriateness of Northwestern Bell's actual debt-equity ratio. It held instead that 6.3 percent of Northwestern Bell's actual equity be disallowed as equity and considered to be imputed debt. This created a hypothetical capital structure of 50.9 percent debt and 49.1 percent equity, instead of the federal court ordered ratios of approximately forty-five percent debt and fifty-five percent equity. This had the legal effect of declaring the federal court-ordered debt-equity ratio to be unreasonable, and the financial effect of lowering Northwestern Bell's revenue by ten million dollars per year.

The action of the Minnesota Public Utilities Commission is barred by the Supremacy Clause for precisely the same reasons announced by the Court on June 24, 1988, in *Mississippi Power & Light Co. v. Mississippi*, 56 U.S.L.W. 4751 (No. 86-1970). In *Mississippi*, the Court held that a decision of the Federal Energy Regulatory Commission ("FERC") that required Mississippi Power & Light Company to purchase thirty-three percent of the output of a nuclear power plant at rates determined by FERC to be just and reasonable preempted the State of Mississippi from inquiring into the prudence of an increase in retail rates sought by Mississippi Power & Light to incorporate that cost. Mississippi Power & Light argued that costs incurred by it pursuant to order of FERC must be recognized by Mississippi as reasonable, and that Mississippi

could not second-guess FERC's determination by the exercise of its authority over state rate-making. The Court broadly interpreted its 1986 decision in *Nantahala Power and Light Company v. Thornburg*, 476 U.S. ___, 90 L.Ed. 2d 943 (1986), and stated:

> The reasoning that led to our decision in *Nantahala* applies with equal force here and compels the same conclusion—states may not alter FERC-ordered allocations of power by substituting their own determinations of what would be just and fair. FERC-mandated allocations of power are binding on the States, and States must treat those allocations as fair and reasonable when determining retail rates.

56 U.S.L.W. at 4756. In both *Nantahala* and *Mississippi*, the Court concluded that states were without authority to set intrastate rates based on their assumption that the utilities' adherence to federal orders was unreasonable.

The Minnesota Public Utilities Commission has attempted to "invade the province of federal authority" in the same way and to the same extent as did the State of Mississippi. 56 U.S.L.W. at 4757. The Minnesota Commission determined it was unreasonable for Northwestern Bell to use, upon divestiture in 1984, the very debt-equity ratio in its capital structure that the federal court, in the exercise of its Tunney Act obligations, ordered Northwestern Bell to use. It decided to ignore the federal court order because it was not entered "for regulatory ratemaking purposes." The federal court's determination may not be collaterally attacked by a state or in the state courts in the exercise of state rate-making authority.[2]

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[2]The decisions of the Minnesota Court of Appeals and the Minnesota Supreme Court were annnounced prior to the United States Supreme Court's June 24, 1988, decision in *Mississippi Power & Light Co. v. Mississippi*, 56 U.S.L.W. 4751 (No. 86-1970) and the Minnesota courts therefore could not have had the benefit of this significant pre-emption decision. In the event that the Court determines not to fully hear this matter, Northwestern Bell respectfully requests that the Court remand the case to the Minnesota courts for reconsideration in light of *Mississippi Power & Light Co. v. Mississippi, supra*. The Court employed this procedure in *Gates v. United States Postal Service*, 470 U.S. 1079 (1985).

In *Nantahala Power and Light Co. v. Thornburg*, 476 U.S. ___, 90 L.Ed.2d 943 (1986), the state was held preempted from setting retail gas rates based on a state's conclusion that the interstate wholesale gas rates approved by the Federal Energy Regulatory Commission ("FERC") under the Natural Gas Act, 15 U.S.C. § 717 *et. seq.*, were unreasonable. *Ibid.*, 90 L.Ed.2d at 954. Although the federal regulators had no direct authority over the regulation of **retail** intrastate gas rates, the state was preempted from rate-making actions based on any conclusion that the federal regulators' decisions were unreasonable. The action of the Minnesota Public Utilities Commission is preempted based on precisely the same logic as was the state's rate-making decision in *Nantahala*: the state may not premise its rate-making on the perceived unreasonableness of a decision by a federal decision-maker in the proper exercise of powers granted by federal statute.

The conclusion that the Public Utilities Commission's action is preempted is also buttressed by the Supreme Court's decision last term of *Schneidewind v. ANR Pipeline Co.*, 485 U.S. ___, 99 L.Ed.2d 315 (1988). The Court held that the regulation of interstate gas rates by FERC pre-empted the state's enforcement of a statute, intended for the protection of the state's ratepayers and investors, regulating the issuance of securities by gas companies. The federal statute, which permitted FERC to impute a reasonable capital structure to the utility if it found the utility's capital structure unreasonable, "permits FERC to control, albeit indirectly [the utility's] capital structure." *Ibid.* at 326. The state's refusal to permit a proposed securities offering based on its belief that the Company would thus be rendered under- or over- capitalized constituted impermissible interference with the federal regulatory authority.

Other state utility regulatory commissions have agreed that for the post-divestiture period, the capital structure requirements of the federal court's Modification of Final Judgment control for rate-making purposes. In *Illinois Bell Telephone Co.*, 57 P.U.R. 4th 225, 263 (Ill. Comm. Comm'n 1983), the Illinois Commerce Commission refused to impute a hypothetical capital structure as a result of the Modified Final Judgment. In *Chesapeake Potomac Tel. Co.* 74 Md. P.S.C. 595 (1983), the Maryland Public Service Commission reached the same result, saying:

> We are persuaded that the MFJ (the federal court order) **leaves no alternative** other than for C&P Telephone Company of Maryland to be divested with a capital structure which is not in excess of 45 percent debt. Since this is a legal requirement established by the U.S. District Court and is binding upon AT&T as well as the divested local operating companies, we conclude that we should adopt a capital structure that conforms with that requirement .... As a consequence, the Modification of Final Judgment will establish, for practical purposes, the maximum amount of debt capital which will comprise the Company's capital structure throughout much of the rate-effective period.

(emphasis supplied).

Thus, as a matter of federal constitutional law, the Public Utilities Commission was precluded from imputing to Northwestern Bell a debt-equity ratio that the Company was prohibited by federal court order from actually using.

II.

Northwestern Bell was deprived of its constitutional right to procedural due process.

In significantly reducing Northwestern Bell's rate increase, the Commission ignored the procedural safeguards of the United States Constitution which protect due process rights. Although the Supreme Court has historically refused to mechanically define "due process" as that phrase is used in the Constitution, *Green v. Frazier*, 253 U.S. 233, 238 (1920), the Court has noted that, with respect to cases involving the deprivation of property, a hearing appropriate in the circumstances is reguired. *See Parratt v. Taylor*, 451 U.S. 527 (1981), *overruled* "to the extent that it states that mere lack of due care by a state official may 'deprive' an individual of life, liberty, or property under the Fourteenth Amendment" by *Daniels v. Williams*, 474 U.S. 327, 330 (1986). Specifically, the Court in *Parratt* stated:

> Our past cases mandate that some kind of hearing is required at some time before a State finally deprives a person of his property interests. The fundamental requirement of due process is the opportunity to be heard and it is an "opportunity which must be granted at a meaningful time and in an meaningful manner."

401 U.S. at 540, *quoting Armstrong v. Manzo*, 380 U.S. 545, 552 (1965); *see also, Market Street Railway Co. v. Railroad Commission*, 324 U.S. 548, 558 (1945) (notice and hearing required). In conjunction with providing parties an opportunity to be heard at a meaningful time and in a meaningful manner, due process requires "that state action, whether through one agency or another, should be consistent with the fundamental principles of liberty and justice which lie at the base of all our civil and political institutions ...." *Hebert v. Louisiana*, 272 U.S. 312, 316 (1926).

With respect to administrative proceedings, the Court has distinguished an agency's rule-making authority (wherein no hearing is required) from it adjudicative authority (wherein a hearing is required). *See United States v. Florida East Coast Railway Co.*, 410 U.S. 224, 244-45 (1973). The distinction that the Court makes is based upon whom is affected by the agency's determination — an entire class of parties or an individual party. If only an individual party is involved, such as a single citizen or a single utility, the agency is said to utilize its adjudicative authority and a hearing is required. *Id. See also, Ohio Bell Telephone Co. v. Public Utilities Commission*, 301 U.S. 292 (1937); *Londoner v. Denver*, 210 U.S. 373 (1908); *cf. Bi-Metallic Investment Co. v. State Board of Equalization*, 239 U.S. 441 (1915). Because the Commission's rate determination covered only Northwestern Bell, it is unquestionable that the Commission was acting in an adjudicative capacity and therefore a hearing was constitutionally required to protect Northwestern Bell's rights to due process.

In sharp contrast to what was required by the Constitution, the Commission, at the time Northwestern Bell's rate increase was reduced in 1987, did not afford Northwestern Bell a meaningful opportunity to be heard on the reduction. No contested case hearing was held. No oral argument before the newly constituted Com-

mission on the factual or legal basis for the adjusted rates was allowed. As a result, the Commission violated Northwestern Bell's procedural due process rights.

This conclusion is not altered by the fact that the Commission held a contested case hearing at the time the original rate increase was considered in 1983. That contested case hearing did not contemplate that the rate determination would ultimately be re-opened by a new Commission some four years later. Consequently, the 1983 hearing cannot satisfy due process requirements. To hold to the contrary, as the Minnesota Court of Appeals did, would allow a utilities commission to reduce utility rates without a meaningful hearing so long as a hearing was held at the prior rate determination. Surely, the opportunity to be heard is required prior to a rate reduction.

In reviewing the Commission's conduct, the Minnesota Court of Appeals committed a number of errors with respect to due process rights in affirming the Commission's rate determination. First, the Court of Appeals ignored the punitive nature of the rate reduction. A need for a hearing is enchanced dramatically by the fact that Northwestern Bell was being punished by the Commission for alleged impropriety at the time the rate was increased in 1984.

Second, in addition to being punitive in nature, the decision to reduce the rate increase was politically motivated in that the Commission was taking action against Northwestern Bell in response to media-induced public perceptions concerning the ratemaking process, rather than facts established on a contested case record. Under these circumstances, it cannot be said that the procedure followed by the Commission conformed with notions of fundamental fairness.

Northwestern Bell was deprived of its property by the Commission without a constitutionally required opportunity to be heard. Such disregard of fundamental procedural safeguards should not have been condoned by the Minnesota Court of Appeals under the guise of deference to an administrative agency. *See St. Joseph Stock Yards Co. v. United States,* 298 U.S. 38, 51 (1936). Therefore, the Supreme Court should grant review of the matter to correct the procedural due process errors committed by the Minnesota Court of Appeals.

III.

The State of Minnesota took Northwestern Bell's property without just compensation.

By ignoring Northwestern Bell's actual capital structure and using a hypothetical capital structure for rate making purposes, the Commission reduced Northwestern Bell's annual rate increase by ten million dollars. In doing so, the Commission has taken property from Northwestern Bell without just compensation in violation of the Fourteenth Amendment of the United States Constitution.

The Supreme Court has spoken numerous times with respect to the standard for determining whether property has been taken without just compensation by government regulatory agencies. The question is whether the Commission's rate structure provides adequate compensation to Northwestern Bell for the loss of its property. The Supreme Court has noted previously that:

> Rates which are not sufficient to yield a reasonable return on the value of the property used, at the time it is being used to render the service, are unjust, unreasonable, and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment.

Bluefield Water Works & Improvement Co. v. Public Service Commission, 262 U.S. 679, 690 (1923). *See also, West v. Chesapeake & Potomac Telephone Co.*, 295 U.S. 662, 671 (1935).

The Court subsequently provided some direction with respect to the interests to be considered in setting rates. In *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), the Court noted:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock .... By that standard the return to the equity owner should be commensurate with returns on investment in other enterprises having corresponding

> risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

320 U.S. at 603 (citations omitted). Thus, the critical issue in determining whether the rate structure constitutes a taking is whether that rate structure guarantees an adequate rate of return on Northwestern Bell's equity so as to provide it with just compensation for the property it loses through the dedication of that equity to public use.

The Commission imputed to Northwestern Bell a hypothetical capital structure that contained a substantially lower amount of equity than Northwestern Bell in actuality had dedicated to its investment in regulated telephone service. As a result, the Commission ignored a portion of the equity on which Northwestern Bell is entitled, by constitutional guarantee, to earn a reasonable rate of return. The Commission thus has prevented Northwestern Bell from earning a fair return on its investment and has taken Northwestern Bell's property without just compensation in violation of the United States Constitution.

CONCLUSION

For these various reasons, the Petition for Certiorari should be granted.

Respectfully submitted,

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Dated: July 5, 1988

88-38 (2)

No. _____

Supreme Court, U.S.
FILED
JUL 5 1988
JOSEPH F. SPANIOL, JR.
CLERK

In the

Supreme Court of the United States

October Term, 1988

NORTHWESTERN BELL TELEPHONE COMPANY,
Petitioner,

v.

MINNESOTA PUBLIC UTILITIES COMMISSION,
Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE MINNESOTA COURT OF APPEALS

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APPENDIX

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APPENDIX 1

OFFICE — JULY 17, 1984

The Commission met on July 17, 1984 with Chairman Adams and Commissioners Crump, Hanson, Hoffman and Kitlinski present.

The following items were passed unanimously by those commissioners present.

P 421 / GR-83-600
Northwestern Bell

Commissioner Hanson moved to reconsider the Commission's previous decision on the transfer of Yellow Pages to U. S. West Direct, capital structure and cost of debt.

The motion passed 5-0.

Commissioner Hoffman moved to disallow the transfer of yellow pages to U. S. West Direct, retain the new U. S. West consolidated capital structure, set the cost of debt of 8.15%, the debt component set at 43.85% resulting in an overall rate of return of 11.71%. The Company shall keep an actual accounting of the expenses and revenues associated with the production of yellow pages.

The motion passed 5-0.

There being no further business, the meeting was adjourned.

APPROVED BY THE COMMISSION
Leo G. Adams, Chairman
Harry Seymour Crump, Commissioner
Roger L. Hanson, Commissioner
Terry Hoffman, Commissioner
Cynthia A. Kitlinski, Commissioner

APPROVAL DATE:
7/24/84

ATTEST:
Randall D. Young
Executive Secretary

APPENDIX 2

BEFORE THE
MINNESOTA PUBLIC UTILITIES COMMISSION

Leo G. Adams	Chairman
Harry Seymour Crump	Commissioner
Roger L. Hanson	Commissioner
Terry Hoffman	Commissioner
Cynthia A. Kitlinski	Commissioner

Docket No. P-421/CR-83-600

In the Matter of the Application of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

Procedural History

On September 29, 1983, Northwestern Bell Telephone Company (Northwestern Bell, NWB or the Company) filed a petition for increased rates with the Minnesota Public Utilities Commission (the Commission), pursuant to Minn. Stat. § 237.075 (Supp. 1983). NWB's originally proposed change in rates would have increased its intrastate annual gross revenues by $109,461,000. In testimony filed February 8, 1984, the Company's proposed revenue increase was revised downward to $98,174,000. In its Initial Brief, filed on April 20, 1984, the Company's requested increase in annual revenue was stated to be $107,587,000.

The Commission accepted NWB's filing and suspended the proposed rates by Order dated October 21, 1983. On that same date, the Commission issued its Notice and Order for Hearing directing that a hearing be conducted on the Company's petition. Adminis-

trative Law Judge Bruce D. Campbell (ALJ) was assigned to the proceeding by the Office of Administrative Hearings.

Pursuant to Minn. Stat. § 237.075, subd. 3 (Supp. 1983), the Commission, by Order dated November 22, 1983, authorized and set the Company's interim rates at a level sufficient to collect $53,778,000 in additional annual revenue, subject to refund, pending a final Order by the Commission. The interim rates became effective for service rendered on and after November 28, 1983.

A prehearing conference was held by the ALJ on November 13, 1983. A Prehearing Order establishing the hearing schedule and procedural guidelines was issued on December 13, 1983. Pursuant to Minnesota Rules, part 1400.6200 Petitions for Intervention were filed and the following were made parties to the proceeding: the Minnesota Department of Public Service (DPS or the Department); the Residential Utilities Division of the Office of the Attorney General (RUD-AG); the Minnesota Department of Administration (DOA); Evan J. Henry, ratepayer; the Minnesota Public Interest Research Group (MPIRG); the Suburan Rate Authority (SRA); North Star Legal Foundation (NSLF): Recipient Families United for Justice (RFUJ); Minnesota Senior Federation (MSF); AT&T Communications of the Midwest, Inc. (AT&T/MW); the Minnesota Business Utility Users Council (MBUUC); the County of Ramsey; the United States Department of Defense on Behalf of the Interest of all Federal Executive Agencies (FEA); Polly Vesser, Renay Post, Sophie Jendro and Cindy Graham, ratepayers (St. Cloud Area Ratepayers or SCAR); the Coalition of FX Users (FX Users); Telecommunications Association of Minnesota (TAM); the Minnesota Radio Common Carriers Association (MRCCA); and NewVector were granted by Commission Orders of February 21, 1984 and March 21, 1984 respectively.

The ALJ conducted evidentiary hearing in St. Paul on January 9, 10–13, 16–20, 23–27 and 30, 1984; March 12–15, 19–23, 26 and 27, 1984; and April 5, 1984.

Appearances at the evidentiary hearings were as follows: James A. Gallagher and Gregory A. Ludvigsen, Attorneys, 200 South Fifth Street, Room 1800, Minneapolis, Minnesota 55402 and Richard A. Karre, Attorney, 1314 Douglas, Omaha, Nebraska 68102, represented Northwestern Bell Telephone Company; Kenneth

A. Nickolai, Susan W. Rester, James T. Jarvis, and Christopher K. Sandberg, Special Assistant Attorneys General, 1100 Bremer Tower, Seventh Place and Minnesota Street. St. Paul, Minnesota 55101, represented the Department of Public Service; Michael J. Bradley, Assistant Attorney General, and Thomas M. O'Hern, Jr., and Dennis D. Ahlers, Special Assistant Attorneys General, Residential Utilities Division, Office of the Attorney General, 340 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, represented the Attorney General, Hubert H. Humphrey: W. Richard Morris, Attorney, 10825 Old Mill Road, Omaha, Nebraska 68154 and Samuel L. Hanson, Attorney, Briggs and Morgan, 2400 IDS Center, Minneapolis, Minnesota 55402 represented AT&T Communications of the Midwest; Carla Kjellberg, and Gail Suchman, Attorneys, 2412 University Avenue Southeast, Minneapolis, Minnesota 55414, represented the Minnesota Public Interest Research Group; Kathleen M. Davis, Attorney, Minneapolis Legal Aid Society, 323 Fourth Avenue South, Minneapolis, Minnesota 55415, represented the Minnesota Senior Federation, Eliot Rothenberg, Attorney, 850 Builders Exchange Building, Minneapolis, Minnesota 55402, represented North Star Legal Foundation; Larry D. Starns, Special Assistant Attorney General, 204 Administration Building, 50 Sherburne Avenue, St. Paul, Minnesota 55155, represented the Minnesota Department of Administration; Lawrence R. McDonough, Attorney, St. Cloud Area Legal Services, 125½ East Broadway, Little Falls, Minnesota 56345, represented Polly Vesser, Renay Post, Sophie Jendro and Cindy Graham, ratepayers; Eldon J. Spencer, Jr., Attorney, 800 Northwestern Center, St. Paul, Minnesota 55101 represented the Coalition of FX Users; Glen E. Purdue and James M. Strommen, Attorneys, 2000 First Bank Place West, Minneapolis, Minnesota 55402, represented the Suburban Rate Authority; Carol Casebolt, Attorney, Legal Aid Society of Minneapolis, 222 Grain Exchange Building, Minneapolis, Minnesota 55415, represented Recipient Families United for Justice; William E. Flynn, Attorney, 3800 IDS Tower, 80 South Street, Minneapolis, Minnesota 55402, represented the Minnesota Business Utility Users Council; Elissa Mautner, Assistant Ramsey County Attorney, 200 Lowry Square, St. Paul, Minnesota 55102, represented the County of Ramsey; Russell L. Doty, Attorney, Suite

814, Degree of Honor Building, 325 Cedar Street, St. Paul, Minnesota 55101, represented the Minnesota Radio Common Carriers Association; Dwight M. Whitley, Attorney, 3350 161st Avenue Southeast, Bellevue, Washington 98008 and John B. Van de North, Attorney, Briggs and Morgan, 2400 IDS Center, Minneapolis, Minnesota 55402, represented NewVector Communications, Inc.; Evan J. Henry, Route 1, Box 60, Winona, Minnesota 55987, appeared *pro se;* and Karl W. Sonneman, Special Assistant Attorney General, and Mark E. Oberlander, Karin F. Leonard, and Everett J. Kulas, 780 American Center Building, 160 East Kellogg Boulevard, St. Paul, Minnesota 55101, represented the Minnesota Public Utilities Commission.

Public hearings to receive customer comments and questions regarding the proposed increase were held on the following dates and in the following locations. Parenthetical numbers indicate the number of persons attending each hearing. Bracketed numbers indicate the number of persons speaking at each hearing.

January 23, 1984	St. Paul	(150)	[12]	1:00 p.m.
January 23, 1984	St. Paul	(15)	[13]	7:00 p.m.
January 24, 1984	Winona	(35)	[18]	
January 25, 1984	Owatonna	(27)	[8]	
January 26, 1984	Marshall	(30)	[11]	
January 27, 1984	Willmar	(2)	[2]	
February 7, 1984	Duluth	(40)	[6]	
February 8, 1984	Virginia	(30)	[6]	
February 9, 1984	Crookston	(4)	[3]	
February 10, 1984	Moorhead	(3)	[1]	
February 21, 1984	Faribault	(140)	[12]	
February 22, 1984	Minneapolis	(500)	[12]	1:00 p.m.
February 22, 1984	Minneapolis	(30)	[12]	7:30 p.m.
February 23, 1984	Cambridge	(100)	[16]	
February 24, 1984	Little Falls	(85)	[14]	

Nineteen public exhibits were received into the record. Several additional public exhibits were offered but later excluded from evidence by the ALJ.

Due to the constraints, the ALJ declined to hold a public hearing in Duluth during the afternoon of February 7, 1984. An

"unofficial hearing" or public gathering was held without the presence of the ALJ. It is asserted that 134 people attended that gathering and an unofficial tape record of the proceeding and an attendance roster were introduced into the record at the evening public hearing as Public Exhibit 2. The ALJ estimatetd that more than 80% of the persons attending the public hearings were senior citizens. In addition to the testimony received at the public hearings, the ALJ received more than 300 letters, all of which were reviewed and included in the record of this proceeding. In the summary of public testimony that is contained in Part III of this Order, no distinction has been made between public oral testimony and public letters.

On April 26, 1984, Northwestern Bell presented to the Commission a proposed corporate restructuring. As part of its presentation, NWB provided documents which it had filed before the Federal Communications Commission (the FCC) which were designed to comply with an FCC order (CC Docket No. 83-115, released on December 30, 1983). The FCC, in that order, imposed the structural separation requirements of 47 C. F. R. § 64.704 on the divested Bell Operating Companies (BOCs) in their offering of customer premises equipment (CPE) and enhanced services if they intended to provide such services after the divestiture. NWB is one of the 22 divested BOCs.

In its presentation before the Commission, NWB informed the Commission that to comply with the FCC's December 30, 1983 Order it would incorporate a new holding company, Northwestern Bell Corporation on April 30, 1984. Northwestern Bell Corporation would have as its subsidiaries Northwestern Bell Telephone Company (NWBT), and Northwestern Bell Information Technologies, Incorporated. NWBT would encompass all present operations of NWB and would be regulated by the Commission. Northwestern Bell Information Technologies, Incorporated would be a new company formed on May 3, 1984, and would not be regulated by the Commission.

On May 4, 1984, the Commission issued an Order directing the DPS to investigate the corporate reorganization of NWB and affiliated corporations and to respond to specific Commission inquiries *In the Matter of an Investigation by the Minnesota Pub-*

lic Utilities Commission into the Corporate Restructuring of Northwestern Bell Telephone Company, Docket No. P-421/CI-84-192.

By letters dated May 8 and 9, 1984, the ALJ, on his own motion, convened a Post-hearing Conference and described to the parties the evidentiary status to be afforded the discussions occurring at the conference. The ALJ stated in a May 9, 1984 letter that his sole purpose in conducting the Post-hearing Conference was to attempt to reach some conclusions about the extent to which the record in this proceeding would reflect the business activities of the divested, reorganized company during the period within which any revised rate may be in effect. He emphasized that the purpose of the Post-hearing Conference was not to extend the hearing to accommodate additional substantive evidence regarding the reorganization of NWB. At the Post-hearing Conference, all counsel present were afforded an opportunity to make oral argument with respect to the matters discussed at the Conference.

Appearances at the Post-hearing Conference were as follows: Melvin R. Quinlan, Attorney, 1314 Douglas on the Mall, Omaha, Nebraska 68102 and James A. Gallagher, Attorney, 200 South Fifth Street, Room 1800, Minneapolis, Minnesota 55402, appeared on behalf of NWB; Kenneth A. Nickolai and Susan W. Rester, Special Assistant Attorneys General, 1100 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, appeared on behalf of the DPS; Thomas M. O'Hern, Jr., and Dennis Ahlers, Special Assistant Attorneys General and Michael J. Bradley, Assistant Attorney General, 340 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, appeared on behalf of the RUD-AG; James M. Strommen, Attorney, 2000 First Bank Place West, Minneapolis, Minnesota 55402, appeared on behalf of the SRA; Samuel L. Hanson, Attorney, 2400 IDS Center, Minneapolis, Minnesota 55402, appeared on behalf of AT&T/MW; Carla Kjellberg, Attorney, 2412 University Avenue S.E., Minneapolis, Minnesota 55414, appeared on behalf of MPIRG; Kathleen M. Davis, Attorney, Minneapolis Legal Aid Society, 323 South Fourth Avenue, Minneapolis, Minnesota 55415, appeared on behalf of the MSF; Larry D. Starns, Special Assistant Attorney General, 204 Administration Building, 50 Sherburne Avenue, St. Paul, Minnesota 55155, appeared on behalf of the DOA; William E. Flynn, Attor-

ney, 3800 IDS Tower, 80 South Eighth Street, Minneapolis, Minnesota 55402, appeared on behalf of MBUUC; Carol Casebolt, Attorney, Minneapolis Legal Aid Society, 222 Grain Exchange Building, Minneapolis, Minnesota 55415, appeared on behalf of RFUJ; Lawrence R. McDonough, Attorney, St. Cloud Area Legal Services, 125½ East Broadway, Little Falls, Minnesota 56345, appeared on behalf of the St. Cloud Area Ratepayers; John B. Van de North, Briggs and Morgan, Attorneys at Law, 2400 IDS Center, Minneapolis, Minnesota 55402, appeared on behalf of NewVector; and Mark E. Oberlander, 780 American Center Building, 160 East Kellogg Boulevard, St. Paul, Minnesota 55101, appeared on behalf of the Commission. In addition, each Commissioner of the Public Utilities Commission was present for all or a significant portion of the Post-hearing Conference.

Pursuant to written Motions, dated May 26, 1984, the following parties to the above-captioned proceedings timely requested that the ALJ recommend to the Minnesota Public Utilities Commission a summary disposition or dismissal of the pending general rate increase requested by Northwestern Bell Telephone Company; the DPS; the RFUJ; the St. Cloud Area Ratepayers; Evan J. Henry; the MPIRG; and the MSF. Such Motions were accompanied by supporting memoranda of law. On May 17, 1984, the DPS entered into a Stipulation with Northwestern Bell (Stipulation), and formally withdrew its previous Motion to Dismiss. On May 18, 1984, Northwestern Bell timely filed a memorandum of law opposing the Motions to Dismiss.

The ALJ submitted the Recommendation of Administrative Law Judge Regarding Motions for Summary Disposition or Dismissal to the Commission on May 22, 1984.[1] The ALJ recommended that the application of NWB for authority to charge its schedule of telephone rates for Minnesota customers be dismissed for failure of the Company to sustain its statutory burden of proof. Minn. Stat. § 237.075, subd. 4 (Supp. 1983).

On May 23, 1984, the Commission met to consider the ALJ's Recommendation of Dismissal. The Commission viewed the Recommendation as a possible final disposition of a contested case

[1] The Commission has exempted portions of that Recommendation herein without specific attribution.

proceeding. Minn. Stat. § 14.61 (1982) provides that in a contested case a final decision cannot be made until the report of the ALJ has been made available to parties for at least 10 days and affords an opportunity for adversely affected parties to file exceptions and present oral argument. Consequently, Oral Argument on the ALJ's Recommendation for Dismissal was held on June 5, 1984. The following parties participated in the Oral Argument: MPIRG, MSF, RFUJ, St. Cloud Legal Services, NWB, DPS, MBUUC, and RUD-AG.

On June 8, 1984, the Commission sent a letter to the ALF stating its belief that due process would best be served by addressing the restructuring issue within the context of this proceeding. The letter stated that the Commission intended, upon rendering a decision on the record of this proceeding to move on its own motion for rehearing on all the additional issues occasioned by the restructuring. The Commission requested that the ALJ issue his Report on the basis of the existing record.

Post hearing briefs were received by the ALJ on May 30, 1984 at which time the record closed.

The ALJ submitted Part I of his Report to the Commission on June 19, 1984. He submitted Part II on June 26, 1984.[2]

The Commission heard Oral Argument on July 9, 1984.

Notice is hereby given that pursuant to Minnesota Rules, part 7830.4100 petition for rehearing or other post-hearing relief, by any party adversely affected, must be filed within 20 days of the mailing data hereof (original plus 11 copies) with Randall D. Young, Executive Secretary, Minnesota Public Utilities Commission, 780 American Center Building, 160 East Kellogg Boulevard, St. Paul, Minnesota 55101, with proof of service on all parties. The grounds relied upon shall be specifically set forth and the claimed errors clearly stated in the petition. If desired, adverse parties may file and serve answers (original plus 11 copies) within 10 days after service of the petition. The Commission may, in its discretion, grant oral argument on the petition or may decide the petition without oral argument.

Now upon review of the entire record herein, the Commission makes the following Findings, Conclusions and Order:

[2]The Commission has exempted portions of that Record herein without specific attribution.

FINDINGS AND CONCLUSIONS

I. JURISDICTION

The subject matter of this proceeding is properly within the jurisdiction of the Commission by virtue of Minn. Stat. Ch. 237, and was properly before the ALJ by virtue of Minn. Stat. §§ 14.48–14.56 (1982) and Minnesota Rules, part 1400.5100 *et seq.* The hearings held herein were convened pursuant to proper notice. The Commission has fulfilled all relevant substantive and procedural requirements of law and has the authority to now act.

II. NORTHWESTERN BELL TELEPHONE COMPANY

Prior to January 1, 1984, Northwestern Bell Telephone Company was an Iowa Corporate, wholly owned by its parent corporation, American Telephone and Telegraph Company (AT&T), which provided telephone service in Minnesota, North Dakota, South Dakota, Nebraska and Iowa. The 22 Bell operating companies, Western Electric Company, Bell Telephone Laboratories and the Long Lines Department were all integrated units of the Bell Telephone System.

When Northwestern Bell's rate application was originally submitted, the Plan of Reorganization filed by AT&T to effectuate divestiture as a consequence of *United States v. American Telephone & Telegraph Co.*, 522 F.Supp. 131 (D.C. 1983), *aff'd*, 103 S. Ct. 1240 (1983), had been approved by the Federal District Court; however, divestiture had not yet taken place.

On January 1, 1984, AT&T divested itself of the Bell Operating Companies (BOCs). Ownership of these companies was transferred to seven new Regional Holding Companies (RHCs). The RHCs are autonomous from each other and from AT&T.

Northwestern Bell Telephone Company, Mountain States Telephone and Telegraph Company and Pacific Northwest Bell Telephone Company are subsidiaries of U.S. West. Inc. (US West), one of the seven Regional Holding Companies resulting from the Plan of Reorganizaton. US West provides service in fourteen states in the Pacific Northwest, Southwest, Rocky Mountains, and Great Plains regions of the country. US West operates several nonregulated subsidiaries. The estimated combined assets of the subsi-

diaries comprising US West were $17 billion on June 30, 1983, with projected operating revenues for 1984 of $7.4 billion.

Northwestern Bell is currently a wholly-owned subsidiary, through an intermediate holding company, of US West and provides telephone service in the same territory both in Minnesota and surrounding states as it did prior to divestiture of the Bell Operating System.

III. SUMMARY OF PUBLIC TESTIMONY

Divestiture

The most often repeated comment by members of the public both in oral and written testimony was a sense of bewilderment and dissatisfaction with the deregulation ordered by the Federal District Court. Many public witnesses testified that they would receive no benefit from deregulation. Proceedings concerning access charges, confusion between service provided by AT&T and NWB and the large requested rate increase by NWB served, in the public perception, only to confirm that opinion. The general sentiment was in favor of a return to the "plain old telephone service" experienced by the average residential ratepayer prior to divestiture.

Many people expressed dissatisfaction over the public information offered by NWB and AT&T with respect to their individual functions. Specific concern was voiced about the lack of adequate 800 number lines by AT&T, AT&T's apparent plans to service certain telephones by mail and the confusion resulting from NWB including in its billings charges for inter-LATA long distance calls for AT&T. A frequently repeated question, especially by the elderly, was whether they should purchase their phone or continue to rent the equipment. An additional problem experienced by many customers is the inability to read and understand Company billings. It was suggested that the form of the bill is confusing and, because of the extremely small print, difficult to read.

There appears to be a public perception that the breakup of AT&T will benefit business and long distance users to the detriment of the individual residential ratepayer. Some public witnesses even suggested that it was the desire of the Company to largely aban-

don concepts of universal service and concentrate on long distance, business service and sophisticated data transmission.

It was suggested that NWB and AT&T coordinate their efforts to explain the services being provided by each and to address matters of public concern caused by divestiture.

***

IV. TEST YEAR

In January of 1982, AT&T and the Department of Justice (DOJ) entered into an agreement to settle an antitrust action commenced by the DOJ against AT&T in 1974. In that settlement agreement, AT&T agreed to a massive restructuring of the Bell System. After protracted proceedings, the United States District Court of the District of Columbia (Divestiture Court) formally approved the settlement in the form of a Modification of Final Judgment (MFJ) on August 24, 1983. One of the major requirements of the MFJ was that AT&T submit a detailed Plan of Reorganization (Plan or POR) which was approved as modified on August 5, 1983, by the Divestiture Court.

On January 1, 1984, the Bell Operating Companies (BOCs), including NWB, were divested from AT&T pursuant to the terms of the MFJ and the POR. As a result of divestiture, the License Contract Agreement with AT&T, the Business Information Systems (BIS) Agreement with Bell Labs, and the Standard Supply Contract with Western Electric were terminated. Under the Plan, assets used solely for exchange telecommunications, exchange access functions, and directory functions were assigned to the BOCs. Conversely, the ownership of customer premises equipment (CPE) and assets used solely for interexchange functions was assigned to AT&T. Assets used to provide both exchange and interexchange functions were assigned on the basis of predominant use. With regard to personnel transfers between NWB and AT&T, the fundamental principle of the Plan was that employees followed their work.

As a result of divestiture and the MFJ, NWB has been restricted in the scope of its activities and services. NWB may no longer provide interexchange telecommunications services. NWB may only

provide exchange service or service within Local Access and Transport Areas (LATAs), provide exchange access for the purpose of originating or terminating interexchange telecommunications (inter-LATA), and provide directory services.

The Company's test year in this proceeding was based on 1983 actual data adjusted as though the Company had operated on a divested basis throughout 1983. The Company utilized a divestiture overlay approach to restate 1983 actual data. NWB projected 1984 investment, revenue, and expense data on both a pre-divestiture and post-divestiture basis and determined a relationship between post-divestiture and pre-divestiture data-divestiture ratios. Those divestiture ratios were applied to actual combined 1983 data to determine post-divestiture operations. Estimated 1984 separation factors were then applied to obtain the intrastate post-divestiture test year data. In developing the divestiture ratios, the Company utilized the Disvestiture Guidelines jointly prepared by AT&T and the BOCs pursuant to the MFJ and in compliance with the POE as the basis for determining the split of revenues, investment, and expenses between NWB and the AT&T entities.

The Company has offered to provide to the Commission a specific intrastate accounting of actual 1984 results, indicating the rate of intrastate return actually realized in the first full post-divestiture year, calculated according to the Commission's own findings. The Company has offered to make appropriate refunds to customers to reduce the earned return for 1984 to the authorized level, in the event that the Company earns in excess of the authorized rate of return during 1984 for intrastate operations.

The RUD-AG advocated that the 1983 test year be presented on a pre-divestiture basis claiming that the divestiture effects incorporated into the revenue requirements of the Company are not known and determinable. The RUD-AG charged that the Company had not adequately supported the reliability of its divestiture overlay procedure and that the Company's refund offer should not be accepted as a substitute for proof.

The DPS recognized that an unadjusted actual 1983 test year cannot be considered representative of NWB's future operations in a post-divestiture environment. Consequently, DPS witness Louiselle presented the test year on a post-divestiture basis. His first approach

was to use a modified divestiture overlay approach similar to that used by NWB. He also presented an alternative approach which was based on the assumption that the revenues NWB lost upon divestiture were producing earnings at the same rate as all other intrastate revenues. His second alternative approach assumed that the divested revenues were earning at the same rate as all of NWB's interstate services.

The ALJ found it appropriate to reflect the effects of divestiture on NWB stating that to ignore divestiture would be to ignore reality. The ALJ also found that the general divestiture overlay approach was the most reasonable method of accounting for the effects of divestiture and for determining prospective rates for NWB. The ALJ also suggested that the Commission require the Company to provide periodic reports during the time revised rates are in effect and that the Company should be required to refund to ratepayers amounts earned in excess of its authorized rate of return. He noted that the Company had volunteered to do so with respect to 1984.

The ALJ found that 1983 revenues and rate base could be measured as if divested directly without the use of the estimation factors contained in divestiture ratios. He found that calculations relying on a direct divestiture of assets and revenues demonstrated that the divestiture ratios developed by the Company with respect to such items tended to understate the Company's revenue requirement. He also found that 1983 expenses could not be divested directly and that it was appropriate to treat investment, revenues, and expenses with a consistenet divestiture overlay technique.

Although the ALJ believed that the process by which the Company developed its divestiture ratios involved a large measure of unverifiable subjectivity, he stated that the Company's direct divestiture of 1983 revenues and investment established the fundamental integrity of the overlay process, at least in regard to revenues and rate base. The ALJ stated that the alternative approach suggested by the Department was not the primary recommendation of its expert witness. The ALJ considered the use of a divestiture ratio overlay approach superior to the alternatives presented by both the DPS and the RUD-AG.

Although the Company generally agreed with the ALJ's findings, it took exception to Findings 52 and 53, which indicated a lack of

evidence and documentation as to how Divestiture Guidelines were applied. The Company pointed out that with regard to investments, the updated divestiture ratios were a direct result of the actual asset transfers to AT&T effective January 1, 1984. The Company stated that the itemization of the asset transfers and company witness Quinn's workpapers that developed the investment overlay percentages based on those transfers are in the record. In rebuttal testimony, Mr. Quinn presented testimony and workpapers showing that a direct divestiture of 1983 revenues indicated that the use of the overlay process for purposes of estimating revenues was conservative in nature. With regard to expenses, witness Yerger testified that the split of expenses was done by each of the operating organizations that were in the best position to apply the Divestiture Guidelines and determine their operational impacts. The split of expenses was accomplished by assessing the job functions that employees were performing and then determining which entity, NWB or AT&T, will perform that job function after divestiture. Job function codes, location codes, and work/time reports were used to help determine the splits.

The Department excepted to the ALJ's adoption of the Company's divestiture overlay approach as "the most reasonable method of accounting for the effects of divestiture." the DPS stated that there was no way to determine the accuracy of the Company's portrayal of post-divestiture expenses until after December 31, 1984. Thus, the DPS contended that it is impossible to state whether the Company's divestiture overlay approach understates or overstates its revenue requiremnet. The DPS argued that its alternative approaches are no more subjective or verifiable than the Company's overlay approach but are equally defensible.

The RUD-AG decided not to except to ALJ's rejection of its position. The RUD-AG stated that the ALJ's acceptance of divestiture ratios in a disaggregated form as adjusted by the DPS and his acceptance of various adjustments proposed by the DPS and RUD-AG resulted in a reasonable approach to this unique and complex issue.

The Commission is in general agreement with the findings, rationale and recommendations of the ALJ that the effects of dives-

titure should be recognized in this proceeding and that a divestiture ratio overlay approach should be utilized to measure the divestiture effects. The Commission agrees that the Company's direct divestiture of 1983 revenues and investment, as indicated in its rebuttal testimony, in rebuttal substantiated the reliability of the overlay process as it relates to revenues and rate base.

The Commission also agrees that the Department's alternative approach was not the primary method sponsored by its expert witness. Very few pages of Mr. Louiselle's supplemental and surrebuttal testimony relate to his two alternative approaches. The revenue loss in his alternative approach was based on a comparison of 1983 intrastate revenue on a pre-divestiture and post-divestiture basis. The post-divestiture revenue used in that comparison was the final revenue number calculated by Mr. Louiselle in his divestiture overlay approach after *pro forma* adjustments. Thus, the divestiture overlay process was utilized to determine the revenue loss in the DPS alternative approach. The Commission believes that the rate base after divestiture can more accurately be determined by use of an overlay approach that is based on the actual asset transfer that occured than by arbitrarily calculating the divested rate base as a function fo revenue loss.

The Commission concludes, as did the ALJ, that the use of the divestiture ratio overlay approach to account for the effects of divestiture is superior to the alternatives presented by both the DPS and the RUD-AG. The Commission will determine whether to use aggregated or disaggregated divestiture ratios as it considers rate base, revenues, and expenses.

The ALJ recommended that the Commission require the Company to report on a period basis its activities during the period of time within which the revised rates remain in effect as a check against the accuracy of the divestiture ratios used in this proceeding. He further recommended that the Commission should require the Company to refund or credit to ratepayers amounts earned in excess of its authorized rate of return. This recommendation was prompted, in part, by NWB's voluntarily offering to make such refunds or credits with respect to 1984.

While the Commission would encourage the Company's voluntary efforts to refund rates that are shown to be excessive when

the haze of divestiture is removed and the actual results are known, the Commission has given little weight to such a refunding proposal since there is no way to enfoce such a proposal. Final rates determined as a result of this case are just that — final rates. As the Commission has recently noted in *Continental Telephone Company*, Docket No. P-407/GR-83-294 (May 14, 1984), p. 2:

> Rate making proceedings have reasonably finite time limits. Indefinite and unknown contingencies should not cloud the Commission's determination of this issue [interest imputed to JDIC portion of rate base] in this case. The Commission also finds that the RUD has not shown that Minn. Stat. § 237.075 (1983) provides the Commission authority to make final approved rates subject to refund as proposed by the RUD.

Once final rates are established, the Commission recognizes that it could lower those rates only prospectively after affording the Company the opportunity for hearing. While the Commission encourages the Company to follow through with its undertaking to refund, its decision on this issue has been made upon the record before it and is not based upon the refunding offer.

V. RATE BASE

In its rebuttal testimony, the Company proposed an average intrastate rate base of $1,005,113,000 on a post-divestiture basis. In its surrebuttal presentation, the DPS recommended a divestiture adjusted intrastate rate base of $1,009,751,000 based on its divestiture overlay approach.

The following Company rate base adjustments were adopted by the DPS without modification: loans under the Special Terminal Equipment Funding Program, removal of paging investment, adjustment for CPE phase-out, and an adjustment to deferred income taxes related to AT&T refunds. The Commission also accepts those adjustments without further discussion.

The individual items comprising the rate base and the proposed adjustments to the rate base, which are in dispute, are discussed in detail in the subsequent paragraphs.

A. Divestiture Ratios

The Company and the DPS applied identical divestiture ratios to the following rate base items: depreciation reserve, plant held for future use, short term telephone plant under construction, accumulated deferred income taxes, pre-1971 investment tax credits, and material and supplies. However for the major rate base item, plant in service, the DPS applied 27 discrete divestiture ratios to the individual component accounts included in plant in service. The Company, on the other hand, applied on composite, aggregated divestiture ratio to average 1983 plant in service to obtain the post-divestiture plant in service.

The DPS stated that Mr. Quinn developed 1984 divestiture ratios for the various plant accounts. Rather than aggregating the impact of all those discrete components and applying the aggregated ratio to 1983 combined average plant in ervce, the DPS applied each discrete ratio to the appropriate, related 1983 plant account. The DPS witness Louiselle stated that in each case where the Company developed discrete divestiture ratios and provided 1983 values for those discrete items, he used those values.

The ALJ found that it was appropriate to use the 27 different plant divestiture ratios reflected in the DPS testimony and exhibits. The ALJ stated that the Company's use of an aggregated ratio for plant in service overstated the effect of divestiture on rate base.

The Company urged the Commission to follow a consistent approach with regard to the use of test year data and with regard to developing divestiture ratios. The Company claimed that the use of disaggregated ratios in some instances, and aggregated ratios in others, can lead to severe distortions that are avoided if the consistent approach utilitized by the Company is followed. The Company stated that while viewed in isolation the use of aggregated ratios for plant accounts may tend to overstate the rate base, the record is clear that the use of a consistent approach for both rate base and revenues would tend to significantly understate the Company's revenue requirement.

The Commission accepts the ALJ's recommendation to use disaggregated divestiture ratios for the various classes of plant included in plant in service. The Commisison believes that the use of disag-

gregated divestiture ratios constitutes a superior method that produces more accurate and reliable results. The Commission finds that the post-divestiture average 1983 plant in service on a combined basis is $2,142,515,000 as calculated in DPS Exhibit 348, Appendix page 2.

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VII. RATE OF RETURN

A. Introduction

NWB sponsored four witnesses to address rate of return issues. Dr. Robert Litzenberger, Professor of Finance at Stanford University, testified to the return on common equity. Mr. Robert B. Morris III, a senior security analyst with Montgomery Securities, also testified to the return on common equity. Mr. William L. Bauhard, Assistant Treasurer of Northwestern Bell Telephone Company, addressed the return on common equity, cost of debt, and capital structure. Mr. Eugene W. Meyer, Vice President and Director of Kidder, Peabody and Company, Inc., tested the adequacy of the Company's requested rate of return on equity and its proposed capital structure.

The DPS sponsored the testimony of Dr. Eilon Amit, Rate Analyst, who addressed the rate or return on common equity, and Dr. Luther C. Thompson, Rate Analyst, who addressed the capital structure and the cost of debt. Dr. Matityahu Marcus, Professor of Economics at Rutgers University, testified to the return on common equity and the capital structure on behalf of the RUD-AG. Dr. Brett A. Smith, Staff Economist or the MPIRG, addressed the rate of return on common equity on behalf of the MPIRG.

The Company proposed the use of a 13.0% overall return on its Minnesota intrastate rate base in calculating its proposed revenue deficiency. The DPS recommended an overall return of 11.76 %. The RUD-AG recommended an 11.60% overall return. The MPIRG limited its testimony to return on common equity and did not recommend an overall rate of return for NWB. The ALJ found an 11.76% overall rate of return to be appropriate.

The Commission will discuss the testimony of each witness and the Report of the ALJ with regard to the rate of return on common equity, capital structure, and cost of debt. The Commission will then make its findings and conclusions and determine the overall rate of return to be authorized for NWB.

B. Testimony of the Witnesses and Report of the ALJ.

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2. Capital Structure and Cost of Debt.

Mr. Bauhard

Mr. Bauhard initially recommended that the Commission adopt NWB's projected post-divestiture capital structure as of 1/1/84. He felt that NWB's capital structure had become the most appropriate means to determine the overall fair rate of return in this proceeding because he no longer relied on AT&T's cost of equity to estimate NWB's cost of equity. This recommendation was a change from the recommendation he made in NWB's previous rate case, *NWB*, Docket No. P-421/GR-82-203, where he recommended that the Commission use the Bell System consolidated capital structure. He felt that the focus on NWB rather than AT&T recognized the effects of divestiture.

Mr. Bauhard began the determination of his recommended capital structure for NWB by first taking the capital structure for NWB at 12/31/83 which consisted of $1.259 billion long term debt, approximately $53 million short term debt and approximately $2.273 billion common equity for a total of $3.585 billion capital. This resulted in a capital structure for NWB at 12/31/83 of approximately 36.6% debt and 63.4% equity.

To determine a projected actual capital structure for NWB as of January 1, 1984, Mr. Bauhard estimated that NWB, at divestiture, would transfer approximately $441 million of its equity to AT&T. The Company would also require additional short term debt financing of approximately $27 million on January 1, 1984. This combined with the $53 million in short term debt as of 12/31/84 would result in about $80 million in short term debt financing for NWB as of 1/1/84. If Mr. Bauhard's estimates were correct, NWB would

have $1.832 billion equity and $1.339 billion debt as of January 1, 1984. The resulting debt to equity ratio would be 42.2% debt to 57.8% equity. Mr. Bauhard argued that this capital structure would barely meet the standards for the Triple-A debt rating NWB enjoyed prior to the divestiture.

In his written rebuttal testimony, Mr. Bauhard updated his recommendation for NWB's capital structure to reflect the fact that NWB transferred approximately $23 million in equity to US West for directory advertising on January 3, 1984. This transfer was financed with $23 million in short term debt. As his final recommendation, Mr. Bauhard urged the Commission to adopt NWB's actual capital structure as of January 3, 1984 which contained 43.6% debt and 56.4% equity.

During his oral rebuttal testimony, Mr. Bauhard mentioned that NWB planned to issue $150 million in long term debt in March 1984. The Company did not recommend any changes in its proposed actual capital structure to reflect the issuance of this debt.

With regard to the cost of debt, Mr. Bauhard initially argued that NWB's average embedded cost of debt was 7.8%. This recommendation was subsequently modified to reflect the January 3, 1984 $23 million short term debt financing. This revision brought the cost of debt up to 7.93%. The Company subsequently changed its 7.93% recommendation to 8.5% to reflect its issuance of $150 million in long term debt securities in March 1984 at a cost of 13.69%.

Mr. Meyer

Mr. Meyer described the financial policies and results necessary for NWB and its parent, US West, to maintain access to the long term credit markets and the equity markets on reasonable terms.

Mr. Meyer examined the coverage ratio and capital structure requirements on long term bond investments as indicated by bond rating agencies. He measured the advantages and disadvantages of various bond ratings to NWB both in terms of cost to the ratepayer and financial flexibility to the Company. In addition, he discussed the importance of stock price to the financibility of US West and its operating companies and, in turn, the importance of earning a rate of return on equity and utilizing a dividend policy which would enable US West to achieve net proceeds of not less than

book value when issuing new common stock.

Mr. Meyer presented the minimum financial requirements of companies necessary to maintain credit ratings at various levels as stated by Standard & Poor's and as followed by Duff and Phelps, and Moody's.

Mr. Meyer felt that it was essential for NWB to maintain a capital structure consistent with triple A and double A ratings to raise additional increments of debt capital in the future.

Mr. Meyer also felt that it was critical that US West adopt a dividend policy necessary to provide a market-to-book ratio of at least 120% and hopefully more. To do this Mr. Meyer felt that it was necessary to have a dividend-to-book ratio of 10.25% to 10.50% and a payout ratio of 66 2/3%. He felt that this dividend policy combined with investor expectations of a growth rate in earning per share of 6.9% to 8.6% per annum should produce a minimum market-to-book ratio of 120%.

In the future, if US West engaged successfully in non-regulated business, Mr. Meyer felt that there should be the opportunity to enhance the market-to-book ratio of the Company, thereby lowering the cost of capital. If the Company was able to issue its new common stock at net proceeds above book value, then the growth rate necessary to attract investors was enhanced and the rate of return on equity necessary to achieve competitive total return declined.

Dr. Thompson

Dr. Thompson recommended that a hypothetical capital structure be used for NWB as of 1/1/84 which consisted of 42.2% debt, 7.8% imputed debt, and 50.0% common equity.

Dr. Thompson argued that the reasonableness of a capital structure for regulatory purposes must be based upon objective benchmarks. He felt that a useful benchmark was an average capital structure for a group of comparable companies.

Dr. Thompson felt that the determination of the actual capital structure of a company was the prerogative of management. However, for regulatory purposes, he argued that it was the Commission which must decide what capital structure is fair and reasonable to use in determining the overall allowed rate of return to be

earned on the utility's rate base. Dr. Thompson felt that the determination of a operational capital structure from an accounting perspective for a utility as a subsidiary of a diversified company was primarily a decision for company management, but where it was appropriate and necessary, the Commission could impose or impute a capital structure different from a compnay-proposed capital structure when it was reasonable to conclude that the proposed capital structure was inappropriate for regulatory purposes.

Dr. Thompson argued that the determination of that capital structure should be made using references to industry comparisons based upon risk relationships and industry averages to determine appropriate benchmarks. Although the Company management had the responsibility of establishing an operational capital structure for a subsidiary, the reasonableness and safety of that imuted capital structure for regulatory purposes rested with the Commission.

Dr. Thompson based his imputed or hypothetical capital structure upon a review of several comparable groups. He considered this a reasonable balance between investors' and consumers' interests. He started with NWB's projected capital structure on 1/1/84 and compared its projected common equity ratio (57.8%) with common equity ratios of comparable groups.

One of his comparable groups consisted of the companies used by Dr. Amit in his cost of common equity analyses. A second and third group were selected based on the testimony of Mr. Bauhard and Mr. Morris, and two additional groups were those used by Dr. Litzenberger. Dr. Thompson also looked at the capital structure used in the last NWB rate case which contained 50.1% common equity.

Dr. Thompson determined his recommended 50% equity ratio by looking at the most recent common equity ratios for the comparable groups. The common equity ratios for these companies ranged from a high of 61.69% (Cincinnati Bell) to a low of 33.54% (Mid-Continent). For a AA regulated company he felt that a 50% equity ratio was appropriate for ratemaking purposes.

Dr. Thompson treated the difference between his proposed 50% equity ratio and the company proposed 57.8% equity ratio as a separate type of capital and assigned to it a current average cost of AA rated debt. AA was the current rating of NWB and was similar to ratings for comparable groups of companies.

Based on his analysis and regulatory considerations, he believed that his recommended capital structure was a reasonable estimate for NWB Minnesota's capital structure for regulatory purposes during the current regulatory period.

Mr. Meyer argued that if the Commission adopted Dr. Thompson's hypothetical capital structure and then it was subsequently adopted by the Company, the Company's bond rating would be, in all probability, downgraded. As a result, the cost of capital would increase and the availability of new capital would decrease.

With regard to the cost of debt, Dr. Thompson felt that 7.8% was a reasonable estimate for the average embedded costs of long term debt for NWB during the current regulatory period. He felt it was consistent with the use of his proposed capital structure. In addition, he believed that the current cost of debt of 12.8% (average from November 1982 to October 1983) contained in Moody's November 1983 bond record for a AA rated utility was a reasonable estimate for regulatory purposes for the excess portion of the common equity he proposed be treated as a separate form of debt (imputed debt).

Dr. Thompson recommended an overall rate of return for NWB of 11.51% using the 7.8% return on long term debt, 12.8% return on imputed debt and 14.46% on common equity.

In its Proposed Findings of Fact and Conclusions of Law, the DPS revised Dr. Thompson's recommendations to reflect updated numbers. The DPS's final recommendation with regard to an appropriate capital structure for NWB and an overall rate of return consisted of 43.6% debt (at an 8.5% cost, increased from the previous 7.93% to reflect the issuance of $150 million in long term debt), 6.4% imputed debt (at a 12.83% cost) and 50% equity (at a 14.46% cost) for an overall cost of capital of 11.76%.

Dr. Marcus

Dr. Marcus testified that the appropriate capital structure should match the entity on which the cost of equity is being based. In this proceeding, he recommended the use of US West on which to base the cost of quity and therefore argued that US West's consolidated capital structure should be used to determine NWB's overall rate of return. US West's consolidated capital structure as of 1/3/84 con-

tained 44.06% debt and 55.94% equity. According to the Company, this capital structure reflected only the consolidated operations of US West's regulated entities, which included NWB, Pacific Northwest Bell, and Mountain States.

Prior to market data being available on US West, Dr. Marcus initially recommended a capital structure containing 45% debt and 55% equity. He employed several guidelines to determine his appropriate capital structure for NWB. These were (1) the capital structures employed by other utilities, (2) the capital structure trends for the Bell System, and (3) the capital structure standards set forth in the Consent Decree.

To observe the capital structure employed by other utilities, Dr. Marcus considered all Aa-rated electric utilities. These utilities averaged a 39.8% common equity ratio. He also considered the common equity ratios of non-Bell telephone utilities. Their average equity ratio was 52.5%. He also reported the financial statistics for another group of telephone companies with significant non-telephone sources of revenues and noted that the average common equity ratio for the group was only 41.7% but that their bond rating was generally weaker (Baa). Finally, he noted that the trend in AT&T's capital structure was of interest.

It was apparent to Dr. Marcus that the Bell System's common equity ratio had been quite stable at about 50% from 1978 through 1980, but had since displayed a sharp increase. Dr. Marcus stated that AT&T's 1982 common equity ratio of 55.6% already represented a rise of 500 basis points in just two years. He said this increase had been justified by AT&T citing the rise in competitive risks.

His initial conclusion that the Commission base its authorized overall rate of return on a capital structure containing 55% common equity and 45% debt was based on the following considerations:

1. NWB's proposed capital structure with 57.8% equity and 42.2% debt was a projection. The actual ratio upon divestuture might differ depending on the actual amount of assets transferred to AT&T.

2. A 55% equity level was significantly higher than the common equity ratio of high grade electric utilities (Aa bond rating).

3. A 55% equity ratio was consistent or higher than the capital structure of non-Bell telephone companies.

4. The 55%–45% mix already reflected the enormous rise in the Bell System's common equity accomplished between 1980 and 1982.

5. The 55%–45% mix was the standard set in the Consent Decree.

6. US West was a new business entity for which no direct risk measures were yet available. A decision to authorize a higher Ratio than 55% should be made only based on explicit evidence.

In its Proposed Findings of Fact and Conclusions of Law, the RUD-AG presented its final recommendation as to the appropriate capital structure for NWB and the resulting overall rate of return. The RUD-AG argued that the evidence in this case supported an overall rate of return of 11.60% based on a capital structure containing 44.06% debt and 55.94% common equity, with the cost of debt being 7.93% and the rate of return on equity capital being 14.5%.

This final recommendation was a result of Dr. Marcus' further testimony that US West's consolidated capital structure should be used as the appropriate capital structure for NWB.

With regard to the cost of debt, Dr. Marcus agreed with Mr. Bauhard's initial updated recommendation of 7.93% as the actual embedded cost of debt for NWB. The RUD-AG did not subsequently accept, however, NWB's revised cost of debt of 8.5%, arguing that it was not adequately supported by record evidence. The RUD-AG, in its Initial Brief recognized that the embedded cost of debt for US West was 8.69%. However, the RUD-AG advised the Commision that if it wished to use, as closely as possible, the costs associated with serving ratepayers, NWB's embedded cost of debt of 7.93% should be used.

The Administrative Law Judge

The ALJ found that NWB did not sustain the burden of proof that the actual capital structure of the Company was appropriate for regulatory purposes. Based on this finding, he determined it was appropriate to attribute to NWB a hypothetical capital structure based on objective tests of propriety.

To determine his hypotheticial capital structure, the ALJ took into consideration several different observations on regulated com-

panies' equity ratios. He determined an average equity ratio of 45.65% for five groups of companies selected by the parties as comparable to NWB and found that figure provided an objective benchmark in judging the capital structure to be assigned to NWB for regulatory purposes. He also determined that the weighted average authorized common equity ratio for regulatory purposes of US West's regulated telephone operations was 51.58%. He found as a consequence of his considerations that it was appropariate to retain the common equity ratio authorized in the NWB's last general rate case, such that the appropriate hypothetical capital structure contained 50.1% common equity and 43.6% debt. He also found it was appropriate to impute to the Company, for inclusion in its capital structure, 6.3% additional debt.

The ALJ recommended that the embedded cost of debt was 8.5%. This reflected the addition of a $150 million debenture issue at a cost of 13.69% during the week of March 18, 1984.

He assigned the latest 12 month average cost of debt, 12.83%, to the 6.3% imputed debt he included in the Company's capital structure.

The ALJ recommended that the Commission authorize an overall rate of return for NWB of 11.76% based on a capital structure that included 50.1% equity (at a 14.46% cost), 43.6% debt (at a 8.5% cost), and 6.3% imputed debt (at a 12.83% cost).

The Company objected to the ALJ's finding that the use of a 50.1% equity ratio in this proceeding would be consistent with the Commission's action in the last NWB rate case. NWB argued that the result was identical to the last case, but the means to achieve that result were not. In NWB's last rate case, the Company proposed and the Commission adopted the Bell System consolidated capital structure excluding Western Electric's equity, that is, the structure of NWB's ex-parent AT&T minus Western Electric equity. NWB argued that if the ALJ had wished to adhere to the precedent of NWB's last rate case, he should have utilized the consolidated capital structure of the three telephone operating companies of NWB's new parent, US West, as the RUD-AG had recommended.

The Company, however, did not recommend the use of the consolidated capital structure, but maintained that its actual capital structure should be used. At a minimum, NWB argued, the Com-

mission should hold that the capital structures of the Bell regional holding companies and the requirements of the MFJ are sufficient evidence to sustain the use of the Company's actual capital structure.

C. Commission Findings and Conclusions.

Introduction

In this proceeding, the Commission was presented with a difficult task regarding the determination of a fair and reasonable rate of return on equity for NWB, the selection of an appropriate capital structure and the determination of the cost of NWB's debt in a post-divestiture environment. The difficulty of the task was exacerbated by the lack of reliable evidence in the post-divestiture period in terms of the evidence's substance and historical perspective upon which the Commission could base its decisions. The transfers of equity to AT&T, a consequence of divestiture, the transfer of equity to US West, a post-divestiture transaction to reflect the transfer of the Yellow Pages advertising operation and telephone directory operations (which the Commission voided, earlier in this Order), and the issuance of debt to finance such transfers further confused and complicated the record because no concrete data was presented by the Company regarding such transfers.

In the past, the Commission has determined the capital structure and rate of return for AT&T and applied the results to NWB, which prior to divestiture was a wholly-owned subsidiary of AT&T. The Company argued in this proceeding that it was no longer appropriate to use AT&T as a proxy for NWB. Instead, the Company recommended that the Commission utilize NWB's actual capital structure for the purposes of determining an overall rate of return. The Company argued that the focus should be shifted away from AT&T and on to NWB to recognize the affects of divestiture. To determined NWB's cost of equity, however, the Company advocated the use of US West as a proxy for NWB.

The Commission agrees with the Company that it is no longer appropriate to use AT&T as a proxy for determining NWB's cost of equity nor should AT&T's capital structure be utilized to determine NWB's overall rate or return. The Commission also agrees with NWB that the determination of a fair and reasonable rate of

return for NWB should utilize US West as a proxy for NWB. Given the lack of historical data on US West that existed during the record of this proceeding, however, the Commission will also utilize data from the six other Bell regional holding companies in its determination of a fair rate of return on equity for NWB.

The Commission will depart from the Company's recommendation regarding the appropriate basis for NWB's capital structure, however, and will focus on US West in order to determine NWB's appropriate capital structure. The Commission believes that shifting the focus to NWB's new parent, US West, more appropriately recognizes the effects of divestiture and the new umbrella organization under which NWB finds itself in the reorganized post-divestiture environment than does focusing exclusively on NWB.

The DPS argued that the lack of reliable market and historical data about NWB's post-divestiture parent US West made it impossible to use US West as a proxy for determining NWB's cost of equity. The DPS also did not advocate the use of US West in the selection of an appropriate captial structure for NWB.

The Commission agrees with the DPS that informative data on US West is lacking historically. However, the Commission finds that the data available on the record regarding US West and the six other Bell regional holding companies as presented in the aggregate by the RUD-AG's witness Dr. Marcus is reasonably reliable evidence upon which to base a decision gives the circumstances of this case where information regarding the post-divestiture environment is lacking from the start. In addition, the Commission finds that the desire to be consistent with past determinations (the use of AT&T as a proxy), when, as in this proceeding, the record justifies consistency with past practices (although AT&T has been replaced by US West) convinces the Commission that the use of US West and the other Bell regional holding companies as a proxy group for determining NWB's rate of return on equity and the utilization of US West's consolidated capital structure to determine NWB's overall rate of return is reasonable and appropriate.

With respect to the appropriate cost of debt, however, the Commission finds that the record of this proceeding demonstrates that debt financing was not coordinated on an integrated, system-wide basis as it was under the AT&T parentage and therefore, the Commission will depart from its past practice of assigning the par-

ent company's consolidated cost of debt when its consolidated capital structure is used.

The Commission will discuss below in more detail its findings and conclusions with respect to NWB's cost of equity, the appropriate capital structure to utilize in determining the overall rate of return to NWB and the cost of debt:

Return on Common Equity

As an administrative agency, the Commision must act both within the scope of its enabling legislation and the strictures of reviewing judicial bodies. Two United States Supreme Court cases provide these general guidelines for Commission rate of return decisions:

1. The allowed rate of return should be comparable to that generally being made on investments and other business undertakings which are attended by corresponding risks and uncertainties.

2. The return should be sufficient to enable the utility to maintain its financial integrity.

3. The return should be sufficient to attract new capital on reasonable terms.

Bluefield Water Works & Improvement Co. v. P.S.C., 262 U.S. 679 (1923), *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

No particular method or approach for determining a rate of return was mandated by those cases, but the necessity of a fair and reasonable rate of return was clearly stated:

> Rates which are not sufficient to yield a reasonable return on the value of the property used, at the time it is being used to render the service, are unjust, unreasonable, and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment. *Bluefield Water Works*, 262 U.S. at 690.

The Minnesota Supreme Court's latest decision on rate of return was stated in *Minnesota Power & Light Company v. Minnesota Public Service Commission*, 302 N.W.2d 5 (Minn. 1980). The Court stated:

> . . . The Single term "ratemaking" has been used to describe what is really two separate functions — (1) the establishment of a rate of return, which is a quasi-judicial function, and (2) the allocation of rates among classes of utility customers, which is a quasi-legislative function.
>
> . . . we now hold that the establishment of a rate of return involves a factual determination which the court will review under the substantial evidence standard.

302 N.W.2d at 9.

In conducting its evaluation of the Commission's decision, the Court explained:

> . . . A reviewing court cannot intelligently pass judgment on the PSC's determination unless it knows the factual basis underlying the PSC's determination. Judicial deference to the agency's expertise is not a substitute for an analysis which enables the court to understand the PSC's ruling. Henceforth, we deem it necessary that the PSC set forth factual support for its conclusion. The PSC must state the facts it relies on with a reasonable degree of specificity to provide an adequate basis for judicial review. We do not require great detail but too little will not suffice.

302 N.W.2d at 12.

In order to provide the factual bais for its decision required by the Court, the Commission has reviewed the testimony of each of the parties on rate of return on common equity, the objections raised thereto by other parties and the recommendation of the ALJ. Based on that review, the Commission makes the following findings with regard to a fair rate of return for NWB's common equity:

The Commissin finds that the DCF method is the appropriate method for estimating NWB's cost of equity. This method is a market-oriented, opportunity cost approach which views the relationship between the cost of equity, investor's income expectations and market price in a theoretically sound and systematic manner. Using the DCF method, an analyst may infer the rate of return investors implicitly require of a particular equity investment. Under

the DCF theory, the return expected by investors is the sum of the expected dividend yield of the stock and the expected growth in dividends.

All witnesses testifying to the rate of return on common equity utilized the DCF method as their primary method. Two company witnesses, Mr. Morris and Dr. Litzenberger, also relied on variations of the risk premium method as secondary methods of analysis. The two main difficulties with the application of a risk premium approach are the need to find firms of comparable risk to the utility in question and the need for a quantifiable and reasonably stable risk premium.

Mr. Morris utilized a conventional risk premium analysis. This method attempts to measure the additional return required by investors in common stock compared to investors in government bonds. The Commission finds that Mr. Morris did not overcome the difficulties associated with the use of the risk premium analysis. Mr. Morris developed his risk premium by taking the average 7.70% risk premium of stock over a firm's cost of long term debt suggested by research done by Ibbotson and Sinquefield. He characterized 7.70% as the market risk premium and multiplied it by his composite group's beta, .61, arguing that the composite's risk premium over debt should be 61% of the market premium as a whole at a minimum. The composite's risk premium then became 4.70% (.61 x 7.70%). If this was Mr. Morris' attempt to justify the comparable riskiness of his risk premium to NWB, his attempt has failed because he did not demonstrate that the average market risk premium was reasonably stable. The Commissin is convinced after reviewing Dr. Amit's exhibit showing various expected risk premiums that the determination of a risk premium value varies depending upon which riskless asset is used to compare with stock returns. Dr. Amit's exhibit also demonstrated that the value of the risk premium is not stable over the years and can vary by as much as 8 percentage points (the risk premiums observed between the years 1951 and 1981 based on U.S. Bonds, A-rated industrial, AAA-rated industrials and AAA composite).

Dr. Litzenberger used a form of the capital asset pricing model (CAPM), which he characterized as a variant of the risk premium approach. The CAPM equates the expected return on a given stock to the return on a riskless asset such as Treasury bills, plus the

premium required on the market as a whole adjusted for the risk of the stock in question. The security-specific risk measure is beta, which measures the extent to which the return on the stock moves with the market as a whole. The CAPM exhibits some of the same shortcomings as the traditional risk premium approach in that the market risk premium is quite volatile and the yield on Treasury Bills or bonds is also subject to rapid change. For example, Dr. Litzenberger's original cost of equity estimate using the CAPM was 17.7% (a combination of the 12.1% yield to maturity on government debt reported on August 8, 1983 and an estimated risk premium of 5.6%). His updated cost of equity estimate four months later was 17.1% utilizing the same CAPM method and the 5.6% risk premium. The yield on the riskless asset, twenty year government debt, had dropped to 11.8% (as reported on Janary 17, 1984). The Commission finds the results of the CAPM and risk premium analyses in this record to be unreliable as guides for determining the appropriate return on equity for NWB.

The Commission finds the DCF method of estimating NWB's cost of equity capital to be reasonable and appropriate in this proceeding. Of the several DCF analyses presented in this proceeding, the Commission finds that the analysis performed on the seven Bell regional holding companies (US West included) as a group by the RUD-AG's witness, Dr. Marcus, is the most appropriate and reliable guide for determining the cost of equity for NWB because it acknowledges the realities of the post-divestiture environment NWB now finds itself in.

In the pre-divestiture past, the Commission based NWB's cost of equity on AT&T's cost of equity. Reliance on AT&T's data was appropriate, because AT&T supplied all of NWB's external equity requirements, and AT&T was risk comparable considering the many operating and financial similarities of the Bell operating companies that comprised AT&T. The divestiture, which severed AT&T from its Bell Operating companies, renders this reliance on AT&T data inappropriate for post-divestiture equity analyses. NWB, as a result of divestiture, became a wholly-owned subsidiary of US West, a Bell regional holding company. US West now provides NWB with all of its external equity requirements.

The Commission finds Dr. Marcus' approach particularly appealing because it recognizes the inadequacies of the financial and

operational data available on US West which prevented the use of estimating the cost of equity of US West directly based only in its own market data and financial characteristics. Dr. Marcus circumvented the problem by aggregating the available data on the seven Bell regional holding companies and analyzing them as a group.

The Commission agrees with the ALJ that the data available for the Bell regional holding companies is limited and lacks historical perspective. When evaluated as separate entities, the Bell regional holding company data is subject to a degree of subjectivity. However, Dr. Marcus used the most representative and reliable data that does exist with respect to the Bell regional holding companies and rather than looking at the companies individually, he analyzed them as a group. The Commission agrees with Dr. Marcus' position regarding the greater reliability for the DCF results for the regional companies as a group than the results for US West alone: the regional companies are new corporate entities functioning in a new environment. Projections for an individual Bell regional holding company will therefore be subject to greater error than projections for established companies with performance records. Averaging the growth projections for the individual regionals will reduce errors contained in individual projections.

Dr. Litzenberger, in his supplemental testimony, presented a DCF analysis on US West. The Commission rejects his analysis because it was based primarily on US West alone and the analysis itself was flawed. The Commission has acknowledged that the data on the Bell regional holding companies individually is limited. Because of the lack of historical perspective particular abberations associated with US West are likely to be heightened. Dr. Marcus' use of the regionals as a group reduced the possible errors and abberations contained in individual projections.

The major flaw in Dr. Litzenberger's DCF testimony, however, was his reliance on security analysts' forecasts to determine an expected growth rate. The Commission has consistently rejected the use of analysts' forecasts as an appropriate method for determining the growth rate (*NWB* Docket No. P-421/GR-82-203). Investment reports frequently offer differing dividend and earnings growth rates, and employ different periods of observation. The methodology underlying their estimates and the use which the analysts make of their estimates are also not uniform. Finally, Dr. Litzenberger did

not provide any evidence that the analysts he cited are representative of the universe of analyst reports.

Mr. Morris' DCF analysis leaves the Commission as bewildered as the ALJ as to how Mr. Morris determined his growth estimate. His recommendation was based heavily upon projections from various sources for growth in the general economy and in the firms which made up his composite group without accompanying evidence in the record regarding the source of such projections or the viability of the assumptions contained in them. This reason alone is sufficient for the Commission to reject Mr. Morris' DCF analysis.

The DCF analysis of Mr. Bauhard is rejected because of his use of analysts' forecasts for his DCF growth component. Mr. Bauhard relied on three investment services. As was mentioned in the discussion of Dr. Litzenberger's DCF testimony, the Commission has previously rejected the use of such forecasts.

The Commission rejects Dr. Smith's DCF analysis for two reasons. First, he did not base his recommendation on an analysis of US West and the Bell regional holding companies. Second, his analysis itself suffers from several deficiencies which in the absence of the Commission's desire to use US West and the Bell regional holding companies as a proxy group, would have rendered Dr. Smith's testimony unreliable upon which to base a recommendation. Specifically, the Commission cannot rely on Dr. Smith's individual growth rate estimates for the companies in his comparable group because Dr. Smith acknowledged in his oral testimony that the individual estimates could not be considered appropriate for each of the respective companies. The Commission agrees with the ALJ that the selection of companies in Dr. Smith's comparable group has considerable influence over the outcome of his analysis because of the large disparities in Dr. Smith's individual growth estimates.

Absent his rejection of the use of US West and Bell regional holding company data, the Commission finds Dr. Amit's DCF analysis to be representative of a consistent application of the DCF method. The Commission will utilize Dr. Amit's analysis as a secondary check on the analysis of Dr. Marcus. Dr. Amit estimated 14.46% as a reasonable return on equity for NWB.

Since the ALJ selected Dr. Amit's testimony to determine his recommended cost of equity, the Commission's findings with respect

to Dr. Amit's testimony apply as well to the ALJ's recommendation. The Commission is confident of its decision in this case, since the ALJ found that Dr. Marcus used the most representative and reliable data that did exist with respect to the Bell regional holding companies.

Dr. Marcus estimated the seven Bell regional holding companies to have an expected growth rate of 5.1%. Although this estimate was based on projections for 1984, the Commission finds that in this proceeding its desire to utilize Bell regional holding company data (even though that necessitates the use of numbers with limited historical perspective) outweighs the use of historical data on groups of telephone companies with comparable risk. Dr. Marcus estimated an average dividend yield of 9.40% utilizing stock prices of a week in duration and 1984 dividend payment projections. Given the lack of historical stock price information on US West, the Commission finds this figure to be appropriate. In subsequent NWB rate cases when more historical data is available on US West the Commission will not hesitate, if record evidence demonstrates it to be appropriate, to use the historical evidence in its determination of expected growth rates and expected dividend yields.

Combining Dr. Marcus' 9.40% dividend yield with his 5.1% expected growth rate results in a rate of return on NWB's common equity of 14.5%. The Commission finds this to be a fair rate of return on NWB's common equity. The Commission will not make any adjustments to this final determination for issuance costs, since US West, in its financial forecast statement of November 8, 1983 stated that it expected to meet all its capital requirements in 1984 through internally generated funds.

Capital Structure

The selection of a capital structure is a major element in the determination of rates and slight variations in the capital structure adopted for regulatory purposes may have significant impacts on a Company's revenue requirements. The capital structure is a financial concept which represents the sources of capital to the Company. Conceptually, the problem for the Commission was to identify what balance between the two major sources of capital, debt and equity, was appropriate for ratemaking purposes, being in the best interests of the Company and its ratepayers. The issue before the Commis-

sion thus becomes, what capital structure is reasonable for ratemaking purposes.

On the basis of the evidence in the record, the Commission finds that the RUD-AG has demonstrated that it would be most prudent and reasonable to use US West's consolidated capital structure for the purposes of determining an overall rate of return for NWB than to use NWB's projected actual post-divestiture capital structure as recommended by the Company. US West's consolidated capital structure consists of only its three regulated telephone company entities — NWB, Pacific Northwest Bell, and Mountain States.

The DPS argued that NWB's capital structure was inappropriate to use for regulatory purposes. In its place, the DPS recommended the use of a hypothetical capital structure containing 50% equity, 43.6% debt and 6.4% imputed debt. The DPS analysis merely demonstrated that NWB's capital structure was not equal to the composite groups its witness, Dr. Thompson, had chosen for comparison purposes. Dr. Thompson never demonstrated that NWB's capital structure was imprudent or unreasonable. The Commission is not convinced by the DPS's argument and has rejected similar arguments in NWB, P-421/GR-82-203 at 32, and *NWB*, P-421/GR-80-911 at 45.

The ALJ recommended the use of a hypothetical capital structure similar to the DPS's with slight modification to make the equity ratio equal to the level authorized in NWB's last rate case, *NWB*, P-421/GR-82-203. The Commission rejects the ALJ recommendation for the same reasons it rejected the DPS's recommendation.

NWB recommended that the Commission adopt its actual capital structure. NWB felt that the adoption of its own capital structure for the purposes of determining the overall rate of return recognized the affects of divestiture. The Company felt that in light of the AT&T break-up there was no longer a consolidated Bell System capital structure and hence it could not be used to set rates. The Commission agrees that since divestiture, the same Bell System consolidated capital structure that the Company advocated using in its last rate case (*NWB*, P-421/GR-82-203), no longer exists and therefore it would be impossible to use that capital structure. However, although the actual entity has disappeared, the principal of using the parent company's consolidated capital structure, which has

been the Commission's consistent practice in the last two NWB rate cases (*NWB*, P-421/GR-82-203, P-421/GR-80-911), did not disappear with Bell System consolidated capital structure. The Commission finds it reasonable and appropriate, therefore, to use the consolidated capital structure of US West, NWB's new post-divestiture parent, to determine the overall rate of return in this proceeding

The Commission finds the appropriate capital structure to consist of 43.85% debt and 56.15% equity. This is US West's consolidated capital structure which includes only the capital of its regulated telephone companies, NWB, Pacific Northwest Bell, and Mountain States, and also reflects the Commission's action earlier in this Order to void the transfer of yellow pages and directory services to US West (i.e. $23 million in equity is returned to NWB's capital structure and $23 million in short term debt is removed from its capital structure).

Cost of Debt

NWB argued in its Reply Brief, at 73, that if US West's capital structure was to be used, its embedded cost of debt must be used as well. This followed from the past practice of the Commission (most recently in *NWB*, P-421/GR-82-203) to apply AT&T's cost of debt to its consolidated capital structure when that structure was used to determine the overall cost of capital for its subsidiary, NWB. The Commission found this practice to be appropriate because the issuance of NWB's debt, although issued by the Company itself, was coordinated by AT&T. The Company, however, has argued, in its Initial Brief, at 129, that debt financing would not be coordinated on the integrated, system-wide basis, as it was in the old Bell System when AT&T was NWB's parent company. In fact, the Company has consistently argued in this proceeding that the realities of the post-divestiture environment demand that the focus be on NWB rather than the parent company in evaluating rate of return issues. In this instance, regarding the cost of debt, the Commission agrees with the Company that the focus should be on NWB and not its parent company. The Commission finds that the use of NWB's embedded cost of debt will reflect more correctly the influence of the Company's cost of debt on its actual operations.

However, due to the lack of actual Company figures on the embedded cost of debt and the lack of evidence on the record

demonstrating the effects of several transfers of equity and infusions of debt capital made by the Company in the course of this proceeding, the Commission finds that it has no alternative but to estimate NWB's embedded cost of debt.

The Commission observes that a cost of debt range exists on the record beginning with the last cost of debt figure agreed to by all parties (7.80% as of 1/1/84) prior to NWB's transfer of yellow pages and directory advertising services to US West and ending with 8.5% (the final updated cost of debt which reflects the debt issuance of $150 million in March, 1984). The Commission finds it reasonable to include the $150 million debt issue since it was known before the close of the record in this proceeding. However, there was some dispute over how that issuance affected NWB's embedded cost of debt. The Company did not provide actual numbers to substantiate its claim that the debt issue increased the Company's embedded cost of debt to 8.5%. In addition, the Commission, earlier in this Order, voided the transfer of $23 million in equity to US West for yellow pages and directory advertising. Concurrent with this equity transfer, the Company incurred $23 million in short term debt financing (which increased the Company's embedded cost of debt from 7.80% to 7.93%).

Since no actual numbers were provided by the Company to verify its constantly changing embedded cost of debt, the Commission cannot back-track to accurately remove the effect of the $23 million in short term debt to reflect the voided transfer, nor can it accurately reflect the effect of the $150 million in new debt. Therefore, it will adopt 8.15%, the average of 7.80% and 8.5% as an appropriate compromise cost of debt for regulatory purposes in this proceeding. The Commission also serves notice to the Company that it must provide, in future general rate proceedings before this Commission, the actual data used to calculate its embedded cost of debt. If during the course of such future proceedings, changes occur in the Company's amount of debt, the effect of such changes on the cost of debt shall also be accurately reflected with actual data.

Overall Rate of Return

Based on the findings and conclusions above, the Commission authorizes an overall rate of return of 11.71% for NWB, calculated as follows:

Source of Capital	% of Total Capital	Cost	Weighted Cost
Debt	43.85%	8.15%	3.57%
Equity	56.15%	14.50%	8.14%
	100.00%		
		Overall Rate of Return	11.71%

VIII. REVENUE DEFICIENCY

Based on the findings and conclusions in the preceding sections of the Order, the Commission authorizes a gross revenue increase of $57,511,000 as caluculated below:

	Dollars in Thousands
Average Test Year Rate Base	$1,023,132
Rate of Return Allowed	11.71%
Required Operating Income	$119,809
Test Year Operating Income	$95,454
Operating Income Deficiency	$24,355
Revenue Conversion Factor	2.2616
Company Revenue Deficiency	$55,081
Increased Toll Settlements	2,430
Total Rate Increase Authorized	$57,511

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X. CORPORATE RESTRUCTURING

As stated in the Procedural History section of this Order, NWB presented a proposed Corporate Restructuring to the Commission on April 26, 1984. The Company stated that the restructuring was designed to comply with an FCC order (CC Docket No. 83-115 released on December 30, 1983). Notification to the Commission

preceeded by only several days the legal implementation of the reorganization. On May 4, 1984, the Commission issued an Order directing the DPS to investigate the corporate reorganization of NWB and affiliated corporations and to respond to specific Commission inquiries. *In the Matter of an Investigation by the Minnesota Public Utilities Commission into the Corporate Restructuring of Northwestern Bell Telephone Company*, Docket No. P-421/CI-84-192.

On May 14, 1984, a Post-hearing Conference was convened by the ALJ on his own motion to try to determine the extent to which the record in this rate case would reflect the business activities of the divested reorganized company during the period within which any revised rate may be in effect. As a consequence of the Post-hearing Conference, Motions to Dismiss were filed. The ALJ in a Recommendation dated May 22, 1984 recommended that the Commission grant the Motions to Dismiss.

On May 23, 1984, the Commission met to consider the ALJ's Recommendation. At that time the Commission established a schedule for Oral Argument on the Recommendation. The Commission viewed the Recommendation as a possible final disposition of a contested case proceeding which is governed by Minn. Stat. § 14.61 (1982). Oral Argument was held on June 5, 1984. In a letter dated June 8, 1984, the Commission requested that the ALJ write his Report on the existing record. The Commission also stated its intention upon rendering a decision on the record of this proceeding to move on its own motion for rehearing in all additional issues occasioned by the restructuring. The Commission indicated that the DPS would have the results of the Commission ordered investigation, and that the results could be used as the basis for additional hearings. The Commission also indicated that this process would provide all interested parties an opportunity to fully participate in the development of restructuring issues. The Commission cited Minn. Stat. § 237.075, subd. 2 (1982) as the source for its authority for ordering additional contested case proceedings on the impact, if any, of restructuring. That section provides in relevant part:

> If the Commission does not make a final determination concerning a schedule of rates within ten months after

the initial filing date, the schedule shall be deemed to have been approved by the Commission. For purposes of this section "final determination" means the inital decision of the Commission and **not any other which may be entered by the Commission in response to a petition for rehearing or other further relief. The Commission may further suspend rates until it determines all those petitions.** (Emphasis added)

The Commission recognizes that this rate case proceeding has been demanding of time, money and effort. Dismissal of the case would result in costs estimated to be $2-3 million which, if determined to be appropriate, would be allowable expenses in NWB's next rate case and would ultimately be borne by the Company's ratepayers. The Commission also realizes that there are many issues which may be unaffected by NWB's restructuring. Therefore, efficiency and economy demand that those issues and the record developed regarding them be preserved. For these reasons, the Commission will deny the Motions for Dismissal filed by the RFUJ, the SCAR, Evan J. Henry, the MPIRG, and the MSF.

Finally, the Commission finds that in order to protect the due process rights of the parties, each should receive the DFS report on the corporate restructuring of NWB and have an opportunity to comment on its findings and the manner in which those findings may affect the determinations made in this rate case. The Commission will so order. After receiving the DFS report and the comments of all parties, the Commission will establish any necessary procedures to address issues arising from the Company's reorganization.

ORDER

1. Northwestern Bell Telephone Company is entitled to increased gross annual revenues of $57,511,000 so as to produce total annual revenues of $649,468,000 from Minnesota intrastate operations.

2. Within 30 days of the service date of this Order, the Company shall file with the Commission for its review and approval, and serve upon all parties in this proceeding, revised schedules of

rates and charges determined in accordance with the total gross annual revenue requirement authorized in paragraph 1 above and the rate design decisions contained herein including the following:

a. The Company shall make no adjustment in its rate calculations for estimated curtailment or shift (repression) of its test year customer base.

b. For each local exchange service provided to both business and residential customers, the Company shall calculate the rates to establish a ratio of 3.0 to 1.0 between the rates for business and residential customers in each tier of the metropolitan exchange, and a ratio of 2.5 to 1.0 between the rates for business and residential customers in the outstate exchanges.

c. The Company shall calculate revised local exchange service rates to eliminate one-half of the difference in rate ratios for local exchange services provided in the metropolitan tier rate zones.

d. The Company shall increase rates for local measured services by the same percentage rates for single-party flat-rate business and residential local exchange services are increased.

e. The Company shall retain all metered local exchange services and increase rates for these services by the same percentage rates for single-party flat-rate business and residential local exchange services are increased.

f. The Company shall retain all multi-party local exchange services and shall increase rates for these services by the same percentage rates for single-party flat-rate business and residential local exchange services are increased.

g. The Company shall set the rates for semi-public coin telephone service at the same level calculated for single-party flat-rate business local exchange service.

h. The Company shall retain the PBX trunk rate designation and shall set the rates for this service at levels equal to

115% of the rates for single-party flat-rate business local exchange service.

i. The Company shall retain the multi-line rate designation for business and residential customers, and shall set rates for these services at levels equal to 105% of the corresponding rates for single-party flat-rate business and residential local exchange services.

j. The Company shall set the revised rates for centrex and group use exchange access lines at the sames levels calculated for PBX trunks.

k. The Company shall increase rates for extended area service by the same percentage single-party flat-rate business and residential local exchange services are increased.

l. The Company shall increase the surcharge for any operator assisted long distance calls presently providing a contribution of less than 25% to a level which will provide a 25% contribution.

m. The Company shall revise rates for touch-tone service provided in association with each category of local exchange service to reflect the rate changes authorized for those services. The Company shall eliminate the touch-tone charge applied to centrex extension stations and apply the same touch-tone rate to business 1-party flat rate local service and semi-public coin telephone service.

n. The Company shall increase rates for custom calling features to the levels it proposed in its initial filing except that it shall set the rate for the speed-calling 8 feature at $1 per month for customers who indicate that the feature is used by a physically or mentally impaired person.

o. The Company shall eliminate the 53¢ directory assistance credit and increase rates for calls to directory service as it proposed in its initial filing.

p. The Company shall increase rates for private line services not involved in the Revised Private Line Case as it pro-

posed in its initial filing.

q. The Company shall implement any other uncontested proposals as it proposed in its initial filing.

3. The Company shall provide, with the schedule of rates and charges referred to in paragraph 2 above, supporting documentation which demonstrates that the proposed schedule of rates will generate the level of revenues authorized in paragraph 1 above.

4. Within 30 days of the service date of this Order, the Company shall file with the Commission for its review and approval, and serve upon all parties in this proceeding, a proposed customer notice explaining the final prospective rates and surcharge, if any.

5. In the event that the Company seeks to implement a rate surcharge under the provisions of Minn. Stat. § 237.075, subd. 3 (Supp. 1983), the Company shall, within 30 days of the service date of this Order, file with the Commission for its review and approval, and serve upon all parties in this proceeding, a proposal whereby the Company will recover the difference between revenues collected from interim rates and the revenues from the rates authorized in this Order from the date of final determination to the date the new rate schedules are put into effect.

6. In the event that any party files a petition for rehearing or other post-hearing relief under Minnesota Rules, part 7830.4100, the time periods specified in paragraphs 2, 3, 4, and 5 above shall be extended to 30 days from the date of Commission decision on all such petitions.

7. Any party wishing to submit comments regarding the filings from paragraphs 2, 3, 4, and 5 above shall submit such comments to the Commission and all parties in this proceeding, in writing, within 10 days of service by the Company.

8. The Company shall, no later than December 31, 1984, submit to the Commission and serve upon all parties in this proceeding a rate proposal for exchange access service provided to customers using multiple line arrangements. The Company shall

submit, along with its rate proposal, a cost study of the additional costs it incurs to provide local exchange service to customers using multiple line arrangements. The Company shall, prior to beginning its cost study, discuss with the Department of Public Service, the Residential Utilities Division of the Office of the Attorney General, and any other party indicating an interest, the appropriate form and design of the cost study.

9. The Company shall, in all future rate case filings, identify the present and proposed test year revenues, and the present and proposed test year number of customers of revenue producing units, for all major categories of service provided to customers or exchange access provided to other carriers.

10. Within 30 days of the service date of this Order, the Company shall submit to the Commission and serve upon all parties in this proceeding a revised rate proposal for services provided to radio common carriers. Pending review of the revised rate proposal, the Company shall, subject to future adjustment, apply existing tariff or contract rates including compensation for intralata toll calls for all services provided to radio common carriers. Any party wishing to submit comments regarding the revised rate proposal shall submit such comments in writing to the Commission, and serve such comments upon all parties in this proceeding, no later than September 27, 1984.

11. The Motions for Dismissal filed by the Recipient Families United for Justice, the St. Cloud Area Ratepayers, Evan J. Henry, the Minnesota Public Interest Research Group and the Minnesota Senior Federation are hereby denied.

12. The Department of Public Service shall, no later than August 1, 1984, submit to the Commission, and serve upon all parties in this proceeding, a report of its investigation regarding the reorganization of Northwestern Bell Telephone Company undertaken *In the Matter of an Investigation by the Minnesota Public Utilities Commission into the Corporate Restructuring of Northwestern Bell Telephone Company*, Docket No. P-421/CI-84-192. Any party wishing to submit comments regarding the DPS report shall submit such comments in writing to the

Commission, and shall serve such comments upon all parties in this proceeding, no later than August 14, 1984.

13. The Company shall maintain a separate acounting of all additional revenues received resulting from the treatment of JDIC allowed by the Commission in computing income tax interest expense for ratemaking purposes in this jurisdiction.

14. The transfer of directory operations and associates assets from Northwestern Bell Telephone Company to U. S. West Direct is hereby declared null and void. The directory operations and associated assets shall be returned to and retained by Northwestern Bell Telephone Company.

15. Within 30 days of the service date of this Order, the Chief Executive Officer of Northwestern Bell Telephone Company shall submit an affidavit to the Commission stating that all directory operations and associated assets have been returned to Northwestern Bell Telephone Company. The affidavit should include a description of the execution and the accounting of this transaction.

16. The Company shall make an annual report regarding the revenues, expenses, and investments associated with the provision of directory operations. In order to comply with this reporting requirement the Company shall, within 30 days of the service date of this Order, submit to the Commission for its review and approval and serve upon all parties to this proceeding, a plan for separately accounting for all revenues, expenses, and investment associated with the provision of all directory operations. Any party wishing to submit comments regarding this plan shall submit such comments in writing to the Commission, and shall serve such comments on all parties in this proceeding within 10 days of service by the Company.

17. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Randall D. Yong
Executive Secretary

SERVICE DATE: July 27, 1984

(SEAL)

APPENDIX 3

BEFORE THE
MINNESOTA PUBLIC UTILITIES COMMISSION

Leo G. Adams	Chairman
Harry Seymour Crump	Commissioner
Roger L. Hanson	Commissioner
Terry Hoffman	Commissioner
Cynthia A. Kitlinski	Commissioner

Docket No. P-421/CR-83-600

In the Matter of the Application of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota

ORDER AFTER RECONSIDERATION AND REHEARING

Procedural History

On September 29, 1983, Northwestern Bell Telephone Company (Northwestern Bell, NWB or the Company) filed a petition for increased rates with the Minnesota Public Utilities Commission (the Commission), pursuant to Minn. Stat. § 237.075 (Supp. 1983).

The Commission accepted NWB's filing and suspended the proposed rates by Order dated October 21, 1983. On that same date, the Commission issued its Notice and Order for Hearing directing that a hearing be conducted on the Company's petition. Administrative Law Judge Bruce D. Campbell (ALJ) was assigned to the proceeding by the Office of Administrative Hearings.

The ALJ conducted evidentiary hearings in St. Paul on January 9, 10–13, 16–20, 23–27 and 30, 1984; March 12–16, 19–23, 26 and 27, 1984; and April 5, 1984.

On April 26, 1984, Northwestern Bell presented to the Commission a proposed corporate restructuring. As part of its presentation,

NWB provided documents which it had filed before the Federal Communications Commission (the FCC) which were designed to comply with an FCC order (CC Docket No. 83-115, released on December 30, 1983). The FCC, in that order, imposed the structural separation requiremnets of 47 C. F. R. § 64.704 on the divested Bell Operating Companies (BOCs) in their offering of customer premises equipment (CPE) and enhanced services if they intended to provide such services after the divestiture. NWB is one of the 22 divested BOCs.

In its presentation before the Commission, NWB informed the Commission that to comply with the FCC's December 30, 1983 Order it would incorporate a new holding company, Northwestern Bell Corporation on April 30, 1984. Northwestern Bell Corporation would have as its subsidiaries Northwestern Bell Telephone Company (NWBT), and Northwestern Bell Information Technologies, Incorporated. NWBT would encompass all present operations of NWB and would be regulated by the Commission. Northwestern Bell Information Technologies, Incorporated would be a new company formed on May 3, 1984, and would not be regulated by the Commission.

On May 4, 1984, the Commission issued an order directing the Minnesota Department of Public Service (DPS) to investigate the corporate reorganization of NWB and affiliated corporations and to respond to specific Commission inquiries *In the Matter of an Investigation by the Minnesota Public Utilities Commission into the Corporate Restructuring of Northwestern Bell Telephone Company*, Docket No. P-421/CI-84-192.

On May 14, 1984, a Post Hearing Conference was convened by the ALJ on his own motion to try to determine the extent to which the record in this rate case would reflect the business activities of the divested reorganized company during the period within which any revised rate may be in effect.

Pursuant to written Motions, dated May 16, 1984, the following parties to the above-captioned proceedings timely requested that the ALJ recommend to the Commission a summary disposition or dismissal of the pending general rate increase requested by Northwestern Bell: the DPS; the Recipient Families United for Justice (RFUJ); the St. Cloud Area Ratepayers (SCAR); Evan J. Henry; the Minnesota Public Interest Research Group (MPIRG); and the

Minnesota Senior Federation (MSF). Such Motions were accompanied by supporting memoranda of law. On May 17, 1984, the DPS entered into a Stipulation with Northwestern Bell (Stipulation), and formally withdrew its previous Motion to Dismiss. On May 18, 1984, Northwestern Bell timely filed a memorandum of law opposing the Motions to Dismiss.

The ALJ submitted the Recommendation of Administrative Law Judge Regarding Motions for Summary Disposition or Dismissal to the Commission on May 22, 1984. The ALJ recommended that the application of NWB for authority to change its schedule of telephone rates for Minnesota customers be dismissed for failure of the Company to sustain its statutory burden of proof. Minn. Stat. § 237.075, subd. 4 (Supp. 1983).

On May 23, 1984, the Commission met to consider the ALJ's Recommendation of Dismissal. The Commission viewed the Recommendation as a possible final disposition of a contested case proceeding. Minn. Stat. § 14.61 (1982) provides that in a contested case a final decision cannot be made until the report of the ALJ has been made available to parties for at least 10 days and affords an opportunity for adversely affected parties to file exceptions and present oral argument. Consequently, Oral Argument on the ALJ's Recommendation for Dismissal was held on June 5, 1984. The following parties participated in the Oral Argument: MPIRG, MSF, RFUJ, SCAR, NWS, DPS, Minnesota Business Utility Users Council (MBUUC), and the Residential Utilities Division of the Office of the Attorney General (RUD—AG).

On June 8, 1984, the Commission sent a letter to the ALJ stating that due process would best be served by addressing the restructuring issue within the context of this proceeding. The letter stated that the Commission intended, upon rendering a decision on the record of this proceeding to move on its own motion for rehearing on all additional issues occasioned by the restructuring. The Commission requested that the ALJ issue his Report on the basis of the existing record.

The ALJ submitted his Report to the Commission in two parts on June 19 and June 26, 1984. The Commission heard Oral Argument on July 9, 1984.

The Commission issued its Findings of Fact, Conclusions of Law and Order on July 27, 1984 (July 27, 1984 Order), authorizing a

rate increase of $57,511,000 exclusive of the test year effects of the corporate restructuring that occured on or about April 30, 1984.

Petitions for Reconsideration or Rehearing of the July 27, 1984 Order were filed by the RUD-AG and NWB on August 6, 1984; by the Minnesota Radio Common Carriers Association (MRCCA), NewVector Communications, Inc. (NewVector), the DPS, and Evan J. Henry on August 16, 1984.

The Company filed Replies to the Petition of the RUD-AG on August 16, 1984 and to the Petitions of the DPS, the MRCCA, NewVector, and Evan J. Henry on August 28, 1984. The RUD-AG and the DPS filed Responses to the Company's Petition for Reconsideration on August 17, 1984. On that same date, the MBUUC filed its Response to the RUD-AG's Petition for Reconsideration.

The July 27, 1984 Order directed the DPS to submit to the Commission and serve upon all parties to this proceeding a report of its investigation regarding the corporate reorganization of NWB undertaken in *NWB*, P-421/CI-84-192. Any party wishing to submit comments regarding the DPS report was directed to do so in writing to the Commission and serve them on all parties no later than August 14, 1984.

On August 1, 1984, the DPS Report in *NWB*, P-421/CI-84-192 (August 1, 1984 Report) was submitted to the Commission and served upon all parties to this proceeding. Comments were filed by the RUD-AG and NWB on August 14, 1984. Neither Mr. Henry, nor any other party, submitted comments. In the August 1, 1984 Resport, the DPS indicated its preliminary findings that the $57,511,000 rate increase authorized in the July 27, 1984 Order should be reduced by $371,000 to reflect the financial impact of the Company's reorganization pertaining to the test year used in this proceeding. The DPS indicated that the $371,000 reduction was a preliminary adjustment which it would subsequently revise to conform with the Commission's findings in the July 27, 1984 Order. On August 24, 1984, the DPS submitted to the Commissin and served upon all parties to this proceeding its revised adjustment of $363,000.

In an Order dated August 27, 1984, the Commission ordered a rehearing in this proceeding. Rehearing was granted for the limited purposes of: 1) receiving the DPS August 1, 1984 Report resulting

from its investigation in *NWB*, P-421/CI-84-192 into the record of this proceeding; 2) determining whether there was cause to go forward to a contested case proceeding regarding the financial impact of NWB's corporate restructuring on this proceeding.

Oral Argument on Petitions for Reconsideration of the July 27, 1984 Order was held on September 11, 1984.

On September 12, 1984, the Commission held a rehearing to receive the DPS August 1, 1984 Report into the record of this proceeding, and to determine whether there was cause to go forward to a contested case proceeding regarding the financial impact of NWB's corporate restructuring on this proceeding.

Supplemental Findings of Fact and Conclusions of Law

The Commission has given limited reconsideration to its July 27, 1984 Order regarding rates for radio common carriers, and amended the final revenue requirement to recognize the test year effects of Northwestern Bell's corporate reorganization.

In addition, the Commission has made supplemental findings regarding the following issues:

1. The transfer of investment tax credits from NWB to American Telephone and Telegraph Company (AT&T);
2. The directory operations;
3. Various isues raised by Evan J. Henry;
4. The rates for radio common carriers;

Further, the Commission has granted a limited stay of its July 27, 1984 Order requiring restoration of directory operations to NWB upon the petition of NWB.

The Commission finds that all other issues raised in the various Petitions For Reconsideraton have been carefully considered by the Commission as discussed extensively in the July 27, 1984 Order, and that no new arguments or evidence have been presented by the parties. Therefore, the Commission concludes that reconsideration should be denied on all other issues not expressly discussed in this Order.

The Commission will also address the test year financial effects

of Northwestern Bell's corporate restructuring.

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IV. Test Year Effect of Corporate Restructuring

In its of July 27, 1984 Order, the Commission ordered the DPS to serve upon all parties in this proceeding by August 1, 1984, a report of its investigation undertaken in *NWB*, P-421/CI-84-192 regarding NWB's corporate restructuring. The July 27, 1984 Order also provided all parties the opportunity to submit written comments on the DPS report no later than August 14, 1984.

The DPS submitted its Report on August 1, 1984. That Report indicated that the effect of the corporate restructuring was to reduce the Company's revenue deficiency in this proceeding by $371,000. The Company and the RUD-AG filed written comments in regard to the DPS report. Neither party contested the DPS report with regard to the impact of the restructuring upon the test year revenue deficiency. Mr. Henry, did not submit comments.

On August 24, 1984, the DPS served a memorandum on all parties which calculated the amended effect of the corporate restructuring as a downward adjustment of $363,000 to the rate increase authorized by the Commission in its July 27, 1984 Order. The amended calculation reflected the cash working capital impact of the adjustments to the test year income statement and the lower rate increase. The revised adjustment also reflected an amendment to the pro forma interest expense and the use of the Commission's allowed rate of return.

On August 27, 1984, the Commission issued its Notice and Order for Rehearing. The following parties appeared at the Rehearing on September 12, 1984: NWB, the DPS, the RUD-AG, MPIRG, Evan J. Henry, and the Department of Defense and the Federal Executive Agencies. None of the parties disputed the accuracy of the $363,000 downward adjustment to the authorized rate increase as set forth in the DPS memorandum of August 24, 1984 or requested further hearings on this matter.

The Commission finds that the previously authorized rate increase of $57,511,000 should be reduced by $363,000 to reflect the test year impact of NWB's corporate restructuring upon this proceeding as outlined in the DPS August 1, 1984 Report, and the DPS memo-

randum of August 24, 1984. The Commission concludes that the Company should be granted a gross revenue increase of $57,148,000, and that further hearings on the test year effect of the corporate reorganization are not required.

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Order

1. Order paragraph 1 of the Commission's July 27, 1984 Order in this proceeding is hereby amended as follows in order to reduce the previously authorized increase in gross annual revenues of $57,511,000 to recognize the $363,000 adjustment proposed by DPS to reflect the test year effects of Northwestern Bell Telephone Company's corporate reorganization:

   1. Northwestern Bell Telephone Company is entitled to increased gross annual revenues of $57,148,000.

2. Order paragraph 10 of the Commission's July 27, 1984 Order in this proceeding is amended as follows:

   10. Within 30 days of the service date of this Order, the Company shall submit to the Commission and serve upon all parties in this proceeding a revised rate proposal for services provided to radio common carrier. Pending review of the revised rate proposal, the Company shall apply rates determined under prior contractual agreements for service provided all conventional radio common carriers as permanent rates, shall apply proposed Feature Group A & E rates for services provided to NewVector as permanet rates, and shall apply the rates originally proposed in *NWB*, P-421/M-84-189 for services provided to MCI/Cellcom Cellular as interim rates.

3. Order paragraphs 14 & 15 of the Commission's July 27, 1984 Order in this proceeding are hereby stayed for a period of 30 days from the effective date of this Order. In the event Northwestern Bell Telephone Company undertakes a court appeal of the Commission's determinations regarding directory operations

as set forth in order paragraphs 14 and 15 of the July 27, 1984 Order in this proceeding, the stay of order paragraphs 14 & 15 shall be extended until such time as the appeal is decided by the courts.

4. Northwestern Bell Telephone Company's request for a stay of order paragraph 16 of the Commission's July 27, 1984 Order in this proceeding is hereby denied. However the time limits specified in the July 27, 1984 Order shall run from the service date of this Order.
5. The Petitions for Reconsideration of Northwestern Bell Telephone Company, the Residential Utilities Division of the Office of the Attorney General, the Minnesota Radio Common Carrier Association, NewVector Communications, Inc., and the Department of Public Service are hereby denied in all other respects.
6. The Petition for Reconsideration and Oral Motions for Dismissal of Evan J. Henry are hereby denied in all respects.
7. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Randall D. Young
Executive Secretary

SERVICE DATE: September 26, 1984

(SEAL)

APPENDIX 4

BEFORE THE
MINNESOTA PUBLIC UTILITIES COMMISSION

Harry Seymour Crump	Chairman
Barbara Beerhalter	Commissioner
Cynthia A. Kitlinski	Commissioner
Robert J. O'Keefe	Commissioner

Docket No. U-999/CI-86-177

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners

ORDER INITIATING INVESTIGATION

FINDINGS AND CONCLUSIONS

On February 19, 1986, the Minnesota Public Utilities Commission (the Commission) issued an Order Vacating December 30, 1985 Order, Dismissing General Rate Case, Discontinuing Interim Rates, and Requiring Refund of Interim Rates in *In the Matter of the Petition of Northern States Power Company for Authority to Change its Schedule of Gas Rates for Retail Customers within the State of Minnesota,* Docket No. G-002/GR-85-108 and *In the Matter of the Proposal of Northern States Power Company for Recovery of Gas Conservation Expenditures,* Docket No. G-002/GR-85-282 (NSP Gas Case). In its February 19 Order the Commission found that improper contacts had occurred between former Commissioner Leo Adams and Northern States Power Company (NSP or the Company) while the Commission was deciding the NSP Gas Case. The Commission determined that NSP's contacts with Commissioner Adams concerning NSP's future employment of Adams had the effect of tampering with the Commission's delibera-

tions in the NSP Gas Case and impairing the integrity of the administrative process.

In an affidavit which was received into the record of the NSP Gas Case, former Commissioner Adams stated: "On October 15, I sent copies of an updated resume to several companies in Minnesota including NSP." This raised the further question whether Adams may have had improper contacts with other Minnesota companies regulated by the Commission while he was a member of the Commission.

Newspaper reports have also disclosed that former Commissioners Juanita Satterlee and Roger Hanson engaged in employment discussions with companies regulated by the Commission while they were members of the Commission. The Federal Bureau of Investigation and the Ramsey County Attorney's Office have reportedly begun criminal investigations into the matter of utility and telephone company contacts with Satterlee, Hanson, and Adams to determine if any criminal laws have been violated.

The Commission believes that it is also necessary to investigate and identify any other Commission decisions that may have been adversely affected by improper contacts between regulated companies and Satterlee, Hanson, and Adams. The Commission will be able to use this investigation to remedy any past decision influenced by improper contacts. Thus, the Commission concludes that an investigation of improper contacts between regulated companies and Satterlee, Hanson, and Adams is appropriate.

The Commission is aware that the Minnesota Department of Public Service (the DPS) has initiated its own investigation into similar matters arising from Commissioner contacts with utilities and telephone companies.

The Commission is authorized by Minn. Stat. §§ 216B.21 and 237.081 (1984) to initiate its own investigation and by Minn. Stat. § 216A.095 (1984) to jointly conduct investigations with the DPS. The Commission may set the scope for its own investigation and ask the DPS to carry out such investigation.

The Commission finds that any investigation relating to the Commission, utilities or telephone companies it regulates should be conducted independently of the Commission to insure public faith in the integrity of the investigation. The Commission further finds that duplicating the DPS's efforts in conducting this investigation

would waste Commission resources and thus would not be in the public interest.

The Commission will initiate its own investigation and direct the DPS to act independently of the Commission in carrying out the investigation. The Commission will equip the DPS with the full powers the Commission now possesses for conducting this investigation. The opening of the Commission investigation is not intended to require the DPS to conduct an investigation different from the independent investigation of the DPS currently underway. Rather, the Commission ratifies and endorses the DPS investigation subject to the directions below. First, the Commission will direct that the investigation cover at least the last several months of the Commission terms of Satterlee, Hanson, and Adams. Second, the Commission will direct the DPS to investigate whether any improper communications occurred during proceedings addressing issues of significant financial impact to regulated companies or addressing issues of significant policy issues likely to lead to a significant financial impact on regulated companies. To assist the investigation, the Commission will provide the DPS with a list of significant Commision decisions. The Commission will aid the DPS in any other appropriate way upon the request of the DPS.

The Commission emphasizes that none of the actions it will be directing the DPS to do are intended to limit in any way the scope of the investigation. The Commission will further direct the DPS to pursue all avenues it determines to be appropriate for a full and independent investigation.

The Commission will also direct the DPS to provide the Commission with a *full report* of the investigation promptly upon its completion so the Commission may determine whether remedies are required to further assure or improve the integrity of the regulatory process.

ORDER

1. The Commission initiates its own investigation and directs the DPS to act independently of the Commission in carrying out the investigation. The Commission confers upon the DPS all the legal powers the Commission now possesses for conducting this investigation.

2. The DPS investigation for the Commission shall cover at least the last several months of the Commission terms of Juanita Satterlee, Roger Hanson, and Leo Adams. The investigation shall be sufficient in scope to assess whether any improper communications occurred during Commission proceedings addressing issues of significant financial impact to regulated companies or addressing significant policy issues likely to lead to a significant financial impact on regulated companies. These are minimum requirements for the scope of the investigation and are not meant in any way to limit the scope of the investigation.

3. The DPS shall pursue all avenues it determines to be appropriate for a full and independent investigation.

4. The DPS shall provide the Commission with a full report of the investigation promptly upon its completion.

5. This Order shall be effective immediately.

BY ORDER OF THE COMMISSION

Mary Ellen Hennen
Executive Secretary

APPENDIX 5

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners

REPORT OF THE DEPARTMENT OF PUBLIC SERVICE TO THE MINNESOTA PUBLIC UTILITIES COMMISSION

I. INTRODUCTION

In January and February, 1986, three former members of the Minnesota Public Utilities Commission, Leo Adams, Juanita Satterlee and Roger Hanson, acknowledged negotiating consulting contracts with regulated utilities while still serving on the Commission. In addition, Hanson acknowledged Northwestern Bell Telephone Company (NWB) had paid him approximately $40,000 for consulting services during the eleven month period between the expiration of his term in Jaunary, 1985 and his reappointment to the Commission at the end of November, 1985.

The Minnesota Department of Public Service (Department) initiated an investigation into the timing and nature of these employment negotiations to determine whether they created conflicts of interest affecting the integrity of the Commission's adjudicatory function. The Department also examined Hanson's consulting arrangement with NWB and its possible effects on decisions he subsequently made as a commissioner. The investigation was conducted pursuant to the authority of the Director of the Department, Minn. Stat. § 216A.07, subd. 1(4), subd. 4. On April 9, 1986, the Commission issued an order directing the Department to continue its own independent investigation and conferring upon the Department the Commission's own investigatory authority.

The Department's investigation into NWB's consulting arrangements with former Commissioners Hanson and Satterlee also revealed a pattern of contacts between NWB's then Assistant Vice

President in charge of regulatory affairs, Roy Weir, and the three former commissioners. Weir's expense records showed he had regular meals with the commissioners, more frequently with Hanson and Adams, and he billed these meals to NWB. These contacts continued and, in some cases, even increased in frequency when NWB had contested matters before the Commission. The Department made a careful examination of these contacts in an attempt to determine whether matters pending before the Commission were discussed.

II. OBJECTIVE AND PURPOSE

The Department's objective in investigating both the employment negotiations and the pattern of contact between NWB and the three commissioners was to ascertain:

1. Which, if any, Commission decisions had been tainted by employment negotiations or arrangements on the part of a commissioner and a regulated utility;

2. The appropriate remedies for proceedings which are tainted;

3. Whether certain actions created an appearance of impropriety jeopardizing the public trust in the Commission; and

4. The steps necessary to eliminate the possibility of similar occurrences in the future.

III. SCOPE

The Department's investigation focused on the following areas:

1. The timing and nature of former Commissioner Satterlee's discussions with NWB representatives regarding a consulting arrangement with that company.
   Time: specific; March 1983–July 1983, and
   general; November 1982–January 1984.

2. The timing and nature of former Commissioner Hanson's negotiations and consulting arrangement with NWB, which involved

payments by NWB through a third party, attorney Robert Johnson.

Time: specific; November 1984–January 1985, and general; November 1984–January 1986.

3. The timing and nature of former Commissioner Adams' efforts to secure employment from regulated companies prior to the expiration of his term.

   Time: July 31, 1985–January 1986.

4. The pattern of contact between NWB and the three commissioners through regular meals at NWB's expense.

   Time: November 1982–October 1983, and April 1984–December 1984.

This report is the result of the Department's investigation and is comprised of the following four sections: Methods; Summary of Facts; Discussion of Issues and Applicable Legal Standards; and Recommendations to the Commission. In addition, the depositions and documents obtained in the course of the investigation are made supporting exhibits to the report to enable the Commission to make an independent evaluation of the facts.

IV. METHODS

There were two parts to the Department's investigation. The first was examination of proceedings during the times when commissioners were engaged in employment negotiations or arrangements. This part was conducted through a review of the Commission actions compiled by both the Department and the Commission. Ex. 15. The second, and more complicated, part was examining the conduct of the affected utilities and the three commissioners.

The Department began its investigation into the negotiations and consulting arrangements of Hanson and Satterlee with letters to NWB asking for the details of these arrangements and for underlying documentation. After receiving NWB's responses, the Department determined it was necessary to depose people with material knowledge about the arrangements. The Department issued subpoenas to Thomas Madison, Roy Weir, Juanita Satterlee, Roger Hanson, Robert Johnson, Leo Adams and Christopher Sandberg. A NWB attorney was allowed to be present at the depositions and to

cross-examine witnesses. Witnesses were also allowed to have their own attorney present at the depositions. The Department informally interviewed other witnesses and secured affidavits from those with material information.

The Department issued subpoenas for documents from NWB and the individual deponents. These subpoenas included a request for all documentation reflecting or pertaining to Assistant Vice President Weir's contacts with the commissioners. In response to the subpoenas, NWB made available, and Department representatives inspected, documents pertaining to Weir's work before the Commission including Weir's expense records. Weir represented, however, that all of his personal calendars were destroyed when he left NWB's employ. W-41.

During the course of the investigation, NWB asserted that all of the documents produced in the investigation, including expense reports, portions of the deposition transcript and informational letters, were trade secret or security information under the Data Practices Act and must be kept confidential after the report was issued to the Commission. Pursuant to Department procedures, the Department determined that only three of the documents produced by NWB were properly classified as security information because they detailed NWB's accounting procedures and listed NWB's internal computer codes. The Department also determined that four internal memoranda were properly classified by NWB as trade secret data. The Department informed NWB on June 10, 1986 that the remaining documents would be classified as public when the Department closed its investigation. Ex. 68.

During the course of the investigation NWB also served interrogatories and a Request for Production of Documents upon the Department. Because NWB requests were not authorized by state law and some requests were irrelevant to the investigation, the Department did not provide the information or documents requested. Ex. 77. However, all relevant documents are being made available to NWB with this report.

When investigating the negotiations between Commissioner Adams and Northern States Power Company (NSP) in January 1986, the Department developed the factual record by requesting information from the company in writing and obtaining a formal written response. The facts of these negotiations are fully set forth

in the Department's motion to dismiss and the Commission's subsequent order dismissing NSP's gas rate case (G002/GR-85-108). Ex. 8. In this investigation the Department examined Adams' job inquiries with other regulated utilities both by deposition questioning and by sending a letter to companies with significant decisions pending before the Commission during the time of Adams' inquiries. These letters requested specific information as to the timing and nature of Adams' employment inquiries. The Department has received a response to each of its investigative letters.

Determining any charges of violations of criminal law are beyond the jurisdiction of the Department and Commission. The Department, therefore, has transmitted copies of all collected pertinent data to the Ramsey County Attorney's Office which is conducting its own investigation.

With few exceptions, the Department has had to rely on the testimony of the former commissioners and NWB representatives in sorting out the contacts between them. In the fact section which follows, the Department has attempted to summarize the factual information contained in the depositions and documents. In addition to considering the findings and recommendations of this report, the Commission is urged to make an independent review of the underlying documentation in assessing the Department's recommendations.

The deposition transcripts are designated as follows:

Satterlee deposition	— S
Hanson deposition	— H
Madison deposition	— M
Weir deposition	— W
Johnson deposition	— J
Adams deposition	— A
Sandberg deposition	— CS

Citation to deposition exhibits refer to exhibits appended to the designated deposition transcript. Other, non-deposition exhibits are identified by exhibit number.

V. SUMMARY OF FACTS

A. EMPLOYMENT NEGOTIATIONS AND CONSULTING ARRANGEMENTS

1. Commissioner Juanita Satterlee

Juanita Satterlee's initial six-year term with the Commission expired in January, 1983. In the fall of 1982, Commissioner Satterlee sought reappointment to a second term. She testified, however, that she had decided at that time not to serve a full term if reappointed. S-26. In November, 1982, the Governor-elect's office informed Satterlee that she would be reappointed to the Commission. S-36. Satterlee stated in her deposition that in January and February of 1983, she was thinking about other employment options, including consulting, and that she discussed these options with her family. S-30-31.

According to Weir's expense records, Satterlee met with him for meals on twelve occasions during February, March and April of 1983.[1] She testified she did not recall discussing her plans to leave the Commission or her idea of trying consulting during those meetings with Weir. S-26-40. Three issues she does recall discussing with Weir during that time were the closing of NWB's business offices around the state, obtaining legislative authority to compensate intervenors in Commission cases, and individual complaints about NWB service. S-34. Other than these issues, she does not recall the substance of her conversations with Weir at those meetings. S-39.

According to his expense records and personal calendar, Thomas Madison, then Vice President and Chief Executive Officer of Minnesota for NWB, met with Satterlee on March 9, 1983. Madison and Satterlee both maintain that they had no discussions about possible employment or consulting arrangements at that meeting, M-50, S-58, although they did discuss issues similar to those Satterlee advised NWB on after becoming a consultant for the utility. S-54. Satterlee recalls that the purpose of the meeting was to discuss the closing of NWB outstate business offices and that they also discussed the Lieutenant Governor's race in the electoral campaign of the previous year. S-57. Madison recalls discussing both the business office closings and the election. Madison's expense records

[1]Satterlee disputes the accuracy of some of the entries in Weir's expense records. S-33.

indicate that they discussed the impact on NWB of legislative activities. Madison Depo. Ex. 6. Madison recalls discussing "something" about the legislature but does not remember what it was. M-55-56.

On April 27, 1983, Satterlee met with the Governor and attempted to submit her resignation. Satterlee said she told the Governor at the meeting that she was probably going into the consulting business. S-48. Satterlee testified that even though she intended to resign immediately after the April 27 meeting, she had no firm plans for post-commission employment. The Governor asked her to take some time to think about her decision and did not accept her resignation that day. S-49, 50. Satterlee subsequently took a leave of absence beginning in late May until early July while she and her family traveled in Europe. She resigned from the Commission July 12, 1983. Her last day as a commissioner was July 29, 1983.

Madison indicated that although he does not remember the exact timing, he learned from Weir close to the time of Satterlee's April 27, 1983 meeting with the Governor that she was leaving the Commission and was interested in becoming a consultant. M-58-61. Satterlee says she did not tell Weir that she intended to leave the Commission until after he meeting with the Governor. S-48. She also believes she talked to Madison regarding possible consulting with NWB after April 27, but she does not recall whether she talked to Weir or Madison first. S-66. Weir testified he learned from the newspaper at the end of April that Satterlee was leaving the Commission. W-107. Sometime after that he discussed with Satterlee her idea about going into the consulting business. W-107-108. Weir stated that after he talked to Satterlee he talked to Madison about her intention to resign. W-110.

According to Madison and Satterlee, sometime after the April 27 meeting and before May 20, they talked about the possibility of Satterlee performing consulting work for NWB. S-70-71. During the conversation Madison told Satterlee to put something in writing for his review. Satterlee stated that after this conversation with Madison she contacted Christopher Sandberg about drafting a consulting contract. S-65. Sandberg is an attorney and at that time worked as a Legal Research Analyst II with the Commission. He testified that he also worked privately out of his home on relatively small and uncomplex legal matters on his own time. CS-6. It was

in this private capacity that Satterlee asked Sandberg to prepare a general consulting agreement for her which would contain enough specifics to be used in discussions with NWB. CS-15. She also asked him to prepare a will because she was going on vacation to Europe near the end of May. CS-20.

At her deposition, Satterlee produced two checks dated April 28, 1983 and May 23, 1983, which she stated were the only payments she made to Sandberg for legal work in the spring of 1983. S-59-60. Sandberg's recollection of the circumstances surrounding his receipt of these checks places the date when Satterlee first approached him about drafting the consulting agreement a number of weeks earlier than April 27, 1983.

Sandberg prepared a will dated May 24, 1983. The consulting agreement he prepared survives only as an undated draft. CS-17. Sandberg stated that he believed, although he was not certain, the May 23, 1983 check was for the will he prepared because he was not asked to prepare the will until, at the most, two weeks before it was executed and he recalls being paid near the date of execution, which was May 24, 1983. CS-23. Based on the circumstances, Sandberg believes the April 28, 1983 check was for the consulting agreement he prepared for Satterlee. CS-24. Satterlee could not recall which check was made in payment for which document. S-62-64.

Sandberg's impression was that Satterlee's conversation with Madison had been quite close to the time she discussed the contract with him, within a week or less. CS-16. Sandberg recalls Satterlee approached him about preparing the consulting agreement sometime in late April or early May. CS-9. Sandberg also recalls, however, that it took "a couple of weeks" to prepare the consulting agreement because he prepared five separate drafts. After each draft he would consult with Satterlee before preparing the next. CS-16. He believes he was paid by check when he completed either the last or about the last draft. CS-18. If Sandberg's recollection about the circumstances of his receipt of these checks is correct, then Satterlee would have had to approach Sandberg in the first half of April about preparing the consulting agreement.

Satterlee and Madison both testified that they met on May 20, 1983, at the Chocolate Mousse Restaurant in St. Paul, and Satterlee gave the draft agreement to Madison at that time. Neither

recalls when or how the meeting was scheduled. S-107, M-66. Both stated that they did not discuss the draft contract during their meeting, rather they discussed more general issues facing NWB. S-107, M-67. Madison stated he did not consider Satterlee's proposal polished, but told Satterlee they would talk further when she returned from Europe. M-69. Satterlee left for her European vacation around May 25, 1983. She resigned from the Commission on July 12, 1983 after she returned from Europe.

In a letter to the Department dated February 28, 1986 regarding the Satterlee consulting arrangement, NWB represented that Madison showed Satterlee's draft proposal to NWB's general attorney, James Gallagher, after the May 20 meeting. Gallagher recalls meeting with Madison in late May. Among the concerns Gallagher expressed in the meeting, was that "as a practical matter and from an appearance standpoint, NWB should not engage in negotiations with Satterlee regarding future consulting while she was a Commissioner, that NWB should not enter into a consulting agreement with her until some reasonable period after she left the Commission (Gallagher suggested January, 1984) and that in the event an agreement was later negotiated it would be advisable to have Satterlee work on matters on behalf of NWB in states other than Minnesota." Madison Depo. Ex. 7, p. 7.

In the spring of 1983. NWB had three significant matters before the Commission. On April 4, 5 and 6 the Commission deliberated and voted on NWB's request for a rate increase of $89,974,080.00, Commission Docket No. P421/GR-82-203, (hereinafter referred to as 82-203). The final vote on the 82-203 order was entered on April 20, 1983. Ex. 79. The Commission denied the petition for reconsideration on May 26, 1986. On May 4, 1983, the Commission voted to permanently authorize the resale of measured WATS and to continue prohibiting resale of full-time WATS, Commission Docket No. P421/82-619; P421/M-83-127 (hereinafter referred to as WATS resale). Ex. 90. In addition, on May 17, 1983, the Commission made its decision in the Basic Six Resale Rates matter, Commission Docket No. P421/M-83-144 (hereinafter referred to as Basic Six). Ex. 84. Basic Six involved setting resale rates for most common telephones which NWB had previously rented to consumers. In all three of these cases, the Commission rendered decisions on disputed issues. Satterlee did not participate in the Commission

deliberation on 83-203 or the vote on reconsideration. She did vote to approve the final order. She also participated in the Basic Six and WATS Resale votes which unanimously favored the company's position.

Madison's expense records and personal calendar indicate a meeting took place at NWB's Minneapolis office between Satterlee and Madison on August 5, 1983. Madision testified he recalled discussing what input Satterlee could have into garnering wider acceptance for local measured service. M-69-70. Madison's testimony is at some variance with NWB's February 28, 1986 letter to the Department which states Madison "attempted to learn from Satterlee what ideas she had as to how she could be of use to NWB in assisting NWB in gaining a better understanding of how the Company is perceived by consumers and how the company can obtain and better utilize consumer input in its decision-making." Madison Depo. Ex. 7, p. 7. Satterlee does not recall this meeting, but assumes the meeting was held. S-110.

During the months of August and September, 1983, Satterlee stated that she was thinking about other employment options but did not pursue any of them. S-111-112. She stated that on September 1, she was "still dickering" with NWB over her possible work for them. S-112, 113. In September she met with Weir and Gene Bier, who had replaced Madison as NWB's Chief Executive Officer in Minnesota, to discuss her possible role as a consultant. Weir stated in his deposition that, even though he had met with Satterlee on several occasions since April, 1983, he did not learn until September 7 or 15 that Satterlee had been discussing a consulting arrangement with NWB. W-125.

Satterlee's first billing statement to NWB covers the period October 3 through November 14, 1983. Initially, she was paid on an hourly basis plus expenses. S-111. The first payment was $8,744. M-76. The first statement from Satterlee contained expenses dating from September 1, 1983. S-113. Nevertheless, Satterlee testified that during November she still considered her consulting arrangement with NWB to be an "iffy matter." S-117. Her second billing statement to NWB was dated December 7, 1983 and covered the period November 14 to December 5, 1983. M-77.

Madison testified that he authorized payment to Satterlee during this time for "data gathering and polishing of her proposal." M-74.

He said the information was not directly associated with her being a consultant instead it was "to help her support with me reasons why we (NWB) ought to be more receptive to some of the consumer concerns going on." M-73.

On December 2[illegible], 1983, Satterlee billed NWB for the sum of $15,805.99 for the months of October through December, 1983. Madison Depo. Ex. 11. Although not designated as such, both Satterlee and Madison stated that this lump sum was an advance payment for the first quarter of 1984. The payment was made in the last quarter of 1983 for Satterlee's tax purposes. S-118, M-31, M-77. Madison acknowledged it was not necessary to designate that the services were rendered in 1983 in order to be taxed in that year. M-79. This quarterly payment amount was subsequently raised to $25,000 during 1984. M-86.

A formal consulting agreement between Satterlee and NWB was never put into writing. According to NWB attorney Stephen Refsell, whether or not an oral or written contract is used with a consultant depended upon the circumstances. M-82. Madison indicated that at first, when there was not a solid agreement about what Satterlee would do during the fall of 1983, an oral contract was used because the terms were not defined. M-20. By the time they moved to the quarterly payment system, Madison testified he saw no need for a written contract because he was comfortable with Satterlee and knew what she was going to do. M-21, 83. Madison testified that it was not until December, 1983, that the Satterlee consulting and payment arrangements were finalized. M-79.

2. Commissioner Roger Hanson

Roger Hanson was appointed to the Commission in 1979 and served until January 1985. He was reappointed in November 1986 and served until his resignation on January 21, 1986.

Hanson had known Weir since 1968 when Hanson served in the Minnesota legislature and Weir was NWB's liaison there. H-39. Hanson testified that during his time on the Commission, he met more frequently with Weir than any other utility representative because Weir was a long-standing friend. H-44.

Hanson testified that in late October, 1984, he learned he would not be reappointed. H-95. On October 25, 1984, Hanson wrote to the Minnesota Association of Commerce and Industry (MACI)

exploring the possibility of working for it at the expiration of his term. Hanson Depo Ex. 2, H-98-99. Sometime in November, 1984, Weir approached Hanson about consulting for the telephone industry. H-99. Hanson stated that he may have talked with Weir about this idea at the National Association of Regulatory Commissioners (NARUC) convention which was held in Los Angeles from November 25 through 30, 1984. H-104.

Weir testified that sometime before the NARUC convention he proposed to NWB's Chief Executive Officer and Vice President of Minnesota Operations, Gene Bier, that NWB and other telephone companies jointly employ Hanson as a consultant for $45,000 a year on issues that might arise during the upcoming 1985 legislative session. W-155, 159. The legislative issues Weir identified were the proposed change in telephone company taxation from gross receipts to ad valorum taxes, universal service and deregulation. Weir testified he received approval from Bier to proceed with discussions of a joint consulting arrangement for Hanson. W-159. He stated he subsequently raised the idea with Ed Tiemann, executive director of the Minnesota Telephone Association (MTA), at the NARUC Convention. W-161.

Weir stated that Tiemann suggested that the services of Hanson be shared by a separate group of companies working through Robert Johnson, MTA's attorney, rather than through the MTA itself. W-161. Tiemann stated by affidavit that he rejected Weir's proposal to work through the MTA because MTA's employment of Hanson could have an appearance of impropriety. He told Weir to talk to Johnson about the propriety of such an arrangement. He also told Weir that Johnson could act on his own to collect payment for Hanson from other telephone companies without MTA approval. Ex. 57.

According to Weir, he next arranged a meeting for December 7, 1984 with Hanson and Johnson. W-165. Hanson stated he knew before the meeting that Weir wanted to arrange for a number of telephone companies to employ him as a consultant, but that he knew nothing of the details. H-104-105. By the date of the meeting, Weir felt NWB had made a qualified, but not final, commitment to the Hanson consulting arrangement. W-172, 175. At the meeting Johnson agreed to collect the funds from other companies to pay Hanson and he recalls discussing a salary range of $40,000

to $45,000. J-21, 28. Weir is unsure whether he discussed the amount of payment with Hanson on that date. W-171, 195. Hanson stated that he did not recall the dollar amount being established. H-112.

During his deposition, Johnson indicated that his first discussion about this matter was with Ed Tiemann at the end of November, 1984. J-12. According to Johnson, the purpose of the December 7 meeting was to see if Hanson was available for consulting for the telephone industry during the 1985 legislative session. J-14–15. He thought Hanson and Weir had discussed the idea before the meeting. J-23.

Hanson testified that at the close of the meeting he believed Weir's idea was a preliminary suggestion to be pursued. H-109. His understanding was that Weir would be responsible for arranging a group of companies and that Johnson would collect the payments and pay Hanson. In turn, Hanson would be a resource person for Johnson and for the telephone industry as a whole. H-109–113.

Johnson testified that he knew of other situations where one telephone company would collect funds from others to pay a shared expense. J-20. He stated, however, that he had never acted as an intermediary in transferring funds to a consultant before. J-20. Weir testified he knew of other instances where law firms were used to make payments to consultants, but he could not give specific examples. W-169. According to Weir, Dick Bartley, NWB's legislative liaison, had told him "there was a law firm doing retainer work on a consulting basis in the legislative arena." W-170. Bartley was under Weir's supervision until June, 1985 when Weir was assigned to other responsibilities. However, in an affidavit submitted to the Department by NWB on June 17, 1986, Weir contradicted his deposition testimony stating that he is not aware of any other situation in which NWB used a law firm to pay a consultant. Ex. 70.

Hanson testified that on December 31, 1984, MACI informed him they did not have a job for him. On January 7, 1985 Hanson met with Weir and Dick Bartley for preliminary discussions concerning his consulting services. H-121–122. On January 18, Hanson called Weir to inquire if his services were needed. Weir told him that the session was off to a slow start but that he should come down to St. Paul. H-119. Weir believed that NWB had made a final commitment to proceed with the arrangement at that time. W-180.

On January 23, Hanson met with Johnson about the consulting arrangement and he had lunch with Weir on January 24. Hanson stated after these meetings he believed the parties had made a commitment to proceed with the consulting arrangement. H-123. No written contact was ever entered into between any of the parties. H-123.

In January and February of 1985 NWB attempted to involve at least two other telephone companies in funding Hanson's consulting contract. Weir asked United Telephone to participate, but United said it would only do so if the employment was done through the MTA. An inquiry was also made to Garden Valley Telephone Cooperative of Erskine by Weir's assistant, Richard McMillen. Garden Valley decided internally not to go along with the funding but no one from NWB ever followed up on the initial contact. Ex. 17.

Hanson did not have actual work assignments in either legislative or non-legislative areas. H-125. He considered himself available to Johnson or any other representatives of the telephone industry who might need advice or research. H-125-126. The only people he spoke with about his work were Weir, Johnson and Bartley. He had no contact with representatives from other telephone companies. H-126. Hanson stated he found the lack of work frustrating and that he could have been consulted more. H-130. Johnson testified that no one contacted him about utilizing Hanson's services, J-33, although he was certain telephone company representatives contacted Hanson directly. J-32. He said he received "seven, eight, nine" phone calls from Hanson during the legislative session asking what he could do and that Hanson come to the capitol several times during the legislative session. Johnson also noted that the quantity of work had fallen below his expectations. J-35.

Johnson said he thought other people in the telephone industry knew Hanson was on a retainer as a consultant, although Johnson personally did not announce Hanson's availability and could not say specifically how people in the telephone industry might know. Johnson thought Tiemann may have announced that Hanson was working as a consultant at an MTA board meeting. J-32-33. Tiemann stated in his affidavit, however, that he does not recall telling anyone Hanson was available as a consultant. In fact, Tiemann stated he had seen Hanson a number of times at the legisla-

ture and Hanson never told him he was working for NWB or any other company. Ex. 57.

Johnson was aware that NWB was the only telephone company being billed for Hanson's services, but he never felt it was his place to tell Hanson. J-56. Hanson stated that he had a strong suspicion that the other telephone companies had not joined NWB in the consulting arrangement by July, 1985 when Weir's job changed, although Weir never told him directly. H-133.

In July, 1985 Jean Keffeler replaced Weir as NWB's assistant vice president in charge of government relations and regulatory affairs. Weir then became assistant vice president for Minnesota operations and his office moved from St. Paul to Minneapolis. Under a new responsibility code, Weir continued to authorize the payments to Hanson from his new position but out of the regulatory and government relations budget which was under Keffeler's authority. W-190. Keffeler has maintained that she did not know payments were being made to Hanson. Madison Depo. Ex. 2, p. 7. Weir says he never told Keffeler that payments were coming out of her budget. W-191.

Each month either Weir or someone from his office would phone Johnson's office and tell them to bill NWB $3,750 for Johnson's services. J-31. Johnson's office would subsequently bill NWB and receive a check from NWB as a "billed fee." Johnson's office would then issue an office check to Hanson. J-39. NWB records indicate that the consulting payments were coded under the category of attorney and arbitrators fees paid to Johnson, rather than legislative consulting fees paid to Hanson. Weir Depo. Ex. 9 (Code 762 identifies expense), Weir Depo. Ex. 10 (defines Code 762 as used for payments to attorneys and arbitrators). Weir stated the use of the attorney and arbitrator code was a mistake. W-197.

Johnson and Hanson both stated that Hanson performed no services after the end of the legislative session. J-51, H-138. Johnson stated that Hanson was under no obligation to provide post-session services because the agreement was for the session only. J-51. However, Weir said it was not his original intent that Hanson's services would be ended after the close of the legislative session. W-184. Hanson testified the payments were made over the entire year because it was easier for him to budget the payments. H-139. From the original conversations, Hanson believed he would

be kept busy throughout the year or at least be available for consulting during the year. But as time went on it became evident to him that NWB did not have anything for him to do beyond the session. H-140. According to NWB in its February 28, 1986 letter to the Department, Bier, NWB's Minnesota Vice President, thought that had NWB's deregulation legislative activities been as active as originally anticipated in early 1985, Hanson would have been called upon to perform more activities than he did. Madison Depo. Ex. 2, p. 8.

In November, after it was announced that Hanson would be reappointed, Weir and Johnson met to discuss a pro-rata final payment to Hanson. Weir wanted to terminate the payments before Hanson's November 25, 1985 reappointment to the Commission. J-53. The last billing from Johnson to NWB was for $2,750 and remains in Johnson's account. J-53-54. According to Hanson's Log, November 21, 1985, was the last day of his consulting contract with Johnson and Weir. Hanson Depo. Ex. 3.

Hanson did not disclose the consulting arrangement with Weir and Johnson in his application for reappointment to the Commission. He stated he used an old resume and did not consider it important to update it. H-140-141. Moreover, in his initial disclosure filing with the Ethical Practices Board, dated November 11, 1985, Hanson did not list any compensation received or due from either Johnson or NWB. According to Hanson he interpreted the line on the form requsting "Source of Compensation" to refer to future compensation. H-142-144. Although he had designated on the form that the period covered began in October, 1985, he did not disclose the $3,750 payment NWB owed him for October according to the payment arrangement. H-46, Hanson Depo. Ex. 5.

On December 11, 1985, a few weeks after Hanson had rejoined the Commission, the commissioners deliberated the New Ulm Toll Project case (P419/NA-84-334) which had been previously heard by an administrative law judge. The New Ulm Toll Project, a consortium of five small telephone companies in the New Ulm area, sought permission to replace NWB as the long-distance carrier between their respective service territories. NWB and the Department originally opposed the request claiming that NWB should retain the right to be the designated carrier in the area. However, both NWB

and the Department argued later that the Commission's decision in the long distance competition case (P999/CI-85-582) had rendered the issue moot.

The Administrative Law Judge had supported New Ulm, although he found NWB's service to be adequate. The Commission ruled that NWB would continue to be the designated carrier until the matter was resolved in the competition case. The Commission found that New Ulm had not proven that NWB agreed to the removal of its toll facilities and that no company can have its certificate revoked without a finding of inadequate service. It also voted to give the New Ulm companies certificates of convenience and necessity to operate in competition with NWB.

Hanson participated in the deliberations and joined the rest of the commissioners present in voting 4-0 in NWB's favor. In discussions after the motion was made, Hanson made one argument favoring NWB: that the Commission made a formal finding of adequate service. He also made one argument not in favor of NWB; that the approval of NWB as the designated carrier, receiving all 1+ intraLATA traffic, was temporary pending the outcome of the competition case. Commission Tapes Dec. 11, 1985. Ex. 91.

On June 20, 1986, the Commission issued an order rejecting New Ulm's request for a reconsideration of its earlier decision. Ex. 89.

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B. PATTERN OF NWB'S CONTACT WITH COMMISSIONERS

During the course of its investigation into the employment negotiations and consulting arrangements of Hanson and Satterlee, the Department discovered that Weir's expense records showed a consistent pattern of contact through meals between Weir and Commissioners Satterlee, Hanson and Adams. Weir frequently met with these commissioners for meals billed to NWB as "quiet business meals." Madison Depo. Ex. 3, Weir Depo. Ex. 11. In addition to meals, Weir stated that he gave sports tickets to commissioners and

staff and various gifts of flowers and other items reflected in his expense reports. W-85, 123. The Department examined Weir's expense records for the time period of September, 1982 through September, 1983 and April, 1984 through December, 1985. Weir Depo. Ex. [illegible].

Weir's expense records also showed that he met with other commissioners and staff members on occasion.[2] However, other than the three former commissioners, the only other Commission employee Weir claimed more than a few meals with was Richard McMillen. During the time period under investigation, McMillen was the supervisor of the Commission's consumer complaints division. He had previously worked as an analyst on telephone matters for the Commission and had before that supervised the Department's telecommunications section. Weir testified he met with McMillen to discuss complaints and other issues because McMillen had "broad background and knowledge in telecommunications issues." W-95. McMillen left the Commission staff in November, 1984 to work for Weir at NWB. He assisted Weir in regulatory relations until July, 1985 when he was assigned other responsibilities. Weir said he did not discuss pending Commission matters with McMillen. W-91.

Weir acknowledged spending less time with certain commissioners than others. He explained the reason as "It was the way it fell, it's the way I felt it was appropriate, I felt it was appropriate at the time." Weir also said that he may have felt it easier for him to spend time with certain commissioners rather than others. W-97, 98. Weir's expense records show he claimed little or no payment for meals with Commissioners Crump, Hoffman, Kitlinski, Lazenberry, or O'Keefe.

Thomas Madison, Weir's immediate superior until June, 1983, and now NWB's Chief Operating Officer, testified that he reviewed Weir's expense records and was aware that Weir was in frequent contact with commissioners through meals at company expense. M-29. Madison said that such contacts were a way of "developing a communications path." M-40. Weir saw his job as a lobbyist "selling a product, selling a service, selling a company." W-55. He felt his meetings with individual commissioners were social meetings and not generally meant as a vehicle to sell any company policies.

[2]The Department has not attempted to verify the accuracy of Weir's records in regard to persons other than the three former commissioners.

Instead they were "to set up a relationship where they (commissioners) would learn more about the company." W-56.

When asked why he met with the commissioners individually, Weir stated he wanted to "have a relationship with them so that whatever problem they saw in our company or proposal they wanted to make about what we should be doing or how we operate . . . whatever they'd have that they would want to share that they'd feel comfortable saying, Roy, we don't think you're doing a good job, and they did that." W-55. Weir stated he would not discuss general rate case matters with individual commissioners but acknowledged that he would feel free to discuss matters not involved in a rate case. W-57.

Weir had a practice of talking to the commissioners about significant cases before NWB filed the case. W-30–34. Before a general rate case Weir would go to individual commissioners and give them an overall view of the need for a filing and the amount needed. W-33, 34. Weir said it was his personal philosophy that commissioners should know in advance when NWB was going to file a significant request. W-33–34. Hanson recalled that Weir had a practice of generally discussing the company's rate case with him before filing. H-27. This practice of advanced notification is clear in the Basic Six case, a disputed non-rate case matter. NWB filed its petition for prices on March 10, 1983. On March 7, Weir took Adams to lunch; March 8 he dined with Hanson and on March 9 Weir claimed payment for taking Satterlee to lunch. Weir's expense statement shows sale of Basic Six telephones as the reason for all three meals. Madison Depo. Ex. 3.

Weir billed meals to NWB by compiling dates and receipts and giving the information to his secretary. His description of the expense included the person present and a short statement of the purpose of the meal. W-96–82, W-76. He said that there were occasional errors in his reports but that overall he tried to make the expense reports an accurate reflection of expenses he incurred. W-78. According to Weir, the stated purpose of meal was sometimes in error because often there was no real purpose, other than just to maintain a relationship. W-79. Weir also said that when a person's name appeared on the column marked "guest" on his expense report it meant he had paid for that person's meal. W-80.

During their depositions Adams, Hanson and Satterlee were

questioned about the discussions they had with Weir at their meals with him. Questions focused on contacts which occurred when a matter involving NWB was pending before the Commission.

Weir's records indicate that between October 1, 1982 and May 26, 1983 he took Satterlee out for meals approximately three times per month. W-99. Weir's records show that on December 15, 1982, he billed NWB $236.35 for a special birthday dinner for Satterlee and her family. W-100. Weir's records also show he billed NWB for a $45.15 birthday gift on February 28, 1983; a $36.09 gift on May 19, 1983, and an $80.00 gift upon her leaving the Commission. W-102. He said that Satterlee never expressed reservations about accepting these meals or gifts, but that on several occasions she did pay for meals they had together. W-103, 104.

Satterlee testified that in general, she had a policy of paying for her own lunches. In practice, however, Satterlee said sometimes she paid and sometimes she let Weir pay. She stated her policy had nothing to do with Weir being a representative of NWB. S-86. Satterlee disputed the accuracy of Weir's expense records asserting that on serveral occasions she was somewhere else. S-33. Satterlee said both Weir and she each had their personal reasons for the meals. Three items on her personal agenda at these meals were closings of NWB's small-town business offices, intervenor compensation and complaints. S-34.

Specifically, Satterlee had no recollection of a March 9, 1983 meal with Weir and stated that on July 19 her mother died and that she did not have a meal with Weir on that date as his records indicate. S-82, 109. She testified she paid by check for her birthday dinner and she thinks her family members also paid for their own dinners on that date. S-91-92.

Weir's records indicate that he took Adams out for meals approximately four times a month. W-134. During the time period examined, Weir claimed payment for 28 meals including Mrs. Adams and Mrs. Weir. According to Weir, business was not discussed at meals involving spouses, nor was it the main purpose of other meals. W-83. Adams stated that there was nothing inappropriate in accepting meals from regulated company representatives. A-40. Adams stated that the reason he allowed Weir to pay was because Weir invited him. He did not dispute the accuracy of Weir's accounts. A-39-40.

In the spring of 1983, the Commission decided NWB's 82-203 rate case. Commission deliberations occurred on April 4, 5 and 6, 1983 and the final order in the case was issed April 20, 1983. Adams was not present for the vote on April 4, but he did have a meal with Weir in St. Paul that day. In his expense records Weir designated the reason for the meal with Adams as "tariff filings." On April 5, the second day of deliberations, Adams was present for the Commission votes and also had a meal with Weir. Weir stated that he did not discuss with Adams why he did not vote on April 4. W-139, W-141. On his expense report Weir designated the meal's purpose as "Basic Six." Adams had no recollection of what he discussed with Weir at these meals on the days of deliberation. A-51, 53.

Adams had two meals with Weir on April 20, 1983 the day of the final vote of the rate increase. The first, apparently lunch, was designated "tariff filings" while the second, apparently dinner, included both Mrs. Weir and Mrs. Adams. When asked about specific meals with Weir that occurred around times when the Commission was considering contested issues involving NWB, Adams had no recollection of what was discussed. He denied discussing issues before the Commission with Weir. He also said he did not consider that it might appear improper that Weir was taking him out to lunch as often as he did. A-93. Adams testified that he would not have discussed rate case issues with Weir on these dates or others because he did not discuss issues pending in contested cases. A-56. He stated that he did not feel his votes were influenced on any Commission matter by his close association or regular contacts with Wier. A-93.

Between April and December, 1984 Hanson and Weir dined together approximately five times a month. H-47-48. At his deposition Weir stated he could not recall what was discussed at most of these meals. W-208-212. Weir specifically denied discussing with Hanson issues that were before the Commission that spring and summer such as the post-hearing conference in the 83-600 rate case, although he had lunch with Hanson the day of the hearing. Weir and Hanson also dined together on June 6, 1984, the day before Hanson issued a letter to the Commission recommending the 83-600 case not be dismissed as Administrative Law Judge Bruce Campbell recommended, and on June 8 the day the Commission

ordered the judge to issue his report. Weir Depo. Ex. 11, 12, 13. Weir also denied discussing other proceedings pending at the time such as the Centrex/Centron case W-232, or the Yellow Pages issues in the 83-600 case W-232.

Hanson stated that often he, Weir and Adams would have lunches on Friday, before Hanson left for his home in Vergas. All three had known each other from the time when Adams and Hanson were in the legislature. H-45. Hanson stated there were a number of reasons for his frequent contacts with Weir in 1984. Hanson said that Weir was a close friend and he valued his advice. During this time period they discussed topics such as the possibility of Hanson running for the legislature, whether Hanson should seek reappointment to the commission, the death of Weir's father, Hanson's ameliorated rates position paper and attempts by Weir to grow hair on his bald spot. H-48–52. Hanson stated that he understood that any discussion of a contested case would be inappropriate. H-58. He did not dispute the accuracy of Weir's expense records, acknowledging that Weir paid for their meals. He stated that he felt it was a common business practice and there was nothing inappropriate about allowing NWB to pay for the meals. H-56. When asked about contacts with Weir during times when contested cases involving NWB were before the Commission, Hanson denied discussing contested issues, although he could not recall what was discussed on those dates. H-67–83. Hanson also stated that he did not believe Weir attempted to influence his vote. H-84.

From April through the end of August 1984, the Commission dealt with a string of important issues affecting NWB and the entire telephone industry. Chief among them was NWB's requested rate increase, Commission Docket No. P421/GR-83-600 (hereinafter referred to as 83-600). Also, during the 83-600 case, Administrative Law Judge Campbell proposed dismissing the case as a result of NWB's belated disclosure of a corporate restructuring. Other non-rate case issues were toll competition (P442,443,444,421,433/NA-84-212), coin telephone competition (P421/C-82-4645), imposition of access charges (P421/CI-83-203), treatment of Centrex/Centron service (P421/M-83-466, P421/M-84-24,25,26), and treatment of NWB's Yellow Pages revenue (P421/CI-80-518).

During that time period Weir had an unusually high number of lunches and dinners with both Adams and Hanson and commis-

sion staffer Richard McMillen. He had 27 meals with Adams, 8 including Mrs. Adams and Mrs. Weir. Weir had 17 meals with Hanson including two with Hanson's wife and Mrs. Weir. In the month of July, 1984 Weir claimed payment for meals on 16 different days with the two commission members and McMillen. The following month, he claimed he dined on 12 different days with Adams, Hanson and McMillen. W-Ex. 11.

C. INVESTIGATIVE REPORTS

Both NSP and NWB have announced they have hired outside counsel to conduct internal investigations of the circumstances and conduct of their companies in relations with the Commission and the hirings of Hanson, Satterlee and Adams.

In announcing the NWB investigation Keffeler was quoted February 28, 1986 by the *Minneapolis Star and Tribune* as saying the company wished "to remove any shadow on its corporate representation as quickly as possible." According to Keffeler, NWB hired the Wall Street law firm of Hughes, Hubbard and Reed because the firm had experience in assisting corporations in internal examinations. Keffeler also said Hughes, Hubbard and Reed was hired because the firm would assure a high-quality, independent probe. The scope of the law firm's inquiry, according to the newspaper, includes all NWB's policies and practices regarding lobbying and campaign contributions. Ex. 17a.

NSP hired Robert Johnson, former Anoka County attorney, (not the Robert Johnson who served as the intermediary in paying Hanson) to review its conduct with Commission members. On April 9, 1986 the *Minneapolis Star and Tribune* quoted NSP spokesman Peter Vanderpoel as saying Johnson was hired "as a matter of prudency" by NSP's Board of Directors. The newspaper quoted Johnson as saying that NSP's Board told him to do "whatever you have to do" in pursuing his investigation. According to Vanderpoel, Johnson's review is expected to last at least until July 1986. Ex. 48a.

VI. DISCUSSION OF ISSUES AND APPLICABLE LEGAL STANDARDS

The above pattern of facts raises a number of issues of grave

importance to the Commission. Some of these issues concern the legality of past decisions involving commissioners who were negotiating employment with parties appearing before them. Others are important because they affect the public's trust in the Commission's integrity.[3] The following sections discuss the issues raised by the investigation and make recommendations for Commission action on each of the issues.

The issues addressed are: A) Whether NWB's consulting arrangements with Hanson and Satterlee created an appearance of conflict of interest which jeopardized the public's trust in the Commission's adjudicatory role; B) Whether the commissioners' employment negotiations or arrangements should have disqualified them from considering certain issues before the Commission and, if so, what are the appropriate remedies; C) Whether the frequent contacts between NWB and individual commissioners through meals sponsored by NWB violated state law or Commission policy; D) Whether the Commission should promulgate rules regarding ex parte contacts on contested cases and any other formal disputed matter; E) Whether an investigation should be ordered into NWB's control of consulting contracts; and F) Whether NSP and NWB should be ordered to disclose copies of internal investigative reports.

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[3]Even NWB agrees that employment discussions can give the appearance of impropriety. In a letter from NWB dated February 28, 1986, Jean Keffeler, then NWB's Assistant Vice President, states:

> During the last several weeks, however, NWB has become aware that such discussions can give the appearance of impropriety. Therefore, NWB has adopted a policy that precludes discussions of employment or consulting arrangements with any Commissioner while still on the Commission. In addition, NWB's policy in the future will be not to hire a Commissioner unless at least one year has elapsed after the leaving of office. Finally, NWB is willing to participate in the development of appropriate Commission and legislative guidelines which will prevent similar situations in the future by making clear the distinction between acceptable and unacceptable activities. NWB continues to recognize the value of the expertise which former Commissioners can bring to a regulated company and its customers. However, NWB recognizes that it has an obligation to avoid any perception of compromising the public trust. Ex. 17, Ex. 18.

A. Whether NWB's Consulting Arrangement with Hanson and Satterlee Created an Appearance of a Conflict of Interest Which Jeopardized the Public Trust in the Commission's Adjudicatory Role.

The consulting arrangements between NWB and Hanson and Satterlee created an appearance of a conflict of interest which jeopardized the public trust in the Commission's impartiality. Inevitably when soon after leaving the Commission, commissioners go to work for the utilities they once regulated, it raises the suspicion that they did not treat their new employer impartially while on the Commission. Moreover, if, as in the case of Commissioners Satterlee and Hanson, the employment relationship is not fully disclosed, the suspicion of past influence is even more damaging to the public trust.

A number of factors have raised questions about the legitimacy of Hanson's consulting arrangement with NWB. First is the method NWB used to pay Hanson through Johnson. Weir, Hanson and Johnson maintain that payments from NWB were made through Johnson because Weir intended to convince other telephone companies to contribute to Hanson's fund. Weir did, in fact, make an effort to contact at least two other companies. Weir testified that he continued authorizing payments to Johnson for Hanson even after it became apparent that no other companies would participate because he felt he had made a commitment to Hanson. While the participants' explanation of the payment arrangement is credible, the method of paying Hanson through a third party has called into question the legitimacy of the arrangement.

Second, it is apparent from the testimony of the participants that neither Hanson, Johnson nor Weir made much of an effort to tell regulated telephone companies that Hanson was available as a consultant. Johnson claims Hanson's services were mainly advertised through Tiemann. In his affidavit, however, Tiemann states he never announced the availability of Hanson's services to anyone. In fact, no one connected with the consulting agreement told Tiemann who Hanson was working for at the legislature. Indeed, Hanson himself claims not to have known who paid him until after the session ended. Weir did not even tell Jean Keffeler, his successor as assistant vice-president, that Hanson was being paid out of her budget.

This failure to disclose has also fueled speculation about the legitimacy of the Hanson/NWB arrangement.

Third, Johnson and Hanson admitted that Hanson was underutilized as a telephone industry consultant and actually only worked with NWB. This apparent underutilization was accentuated because Hanson's payments were amortized over the entire year even though he only worked during the legislative session. While many consultants are often kept on retainer even when they are not utilized, NWB's payments to Hanson for minimal work immediately following completion of his term as a commissioner was questionable in light of the other circumstances.

Finally, Hanson's failure to disclose his consulting activities at the time he applied for and then later accepted reappointment to the Commission has raised questions about the consulting arrangement. Hanson did not state in either his application to the Governor or in his initial ethical practices statement that he had done consulting work for one or more telephone companies. These omissions, together with the other circumstances described above, has given the impression that the consulting arrangement was intentionally concealed.

The facts surrounding former Commissioner Satterlee's consulting arrangements has also prompted speculation. Unlike Hanson, NWB paid her directly. Like Hanson, however, she began negotiations while a commissioner, did not have a written contract, and her consulting work for the company began soon after her resignation from the Commission. In Hanson's case it was a month, and with Satterlee it was two and one-half months, though she was being paid for expenses a little over a month after leaving the Commission. Her direct dealing with Madison and NWB's initial payments to her to polish her proposal implies that she was given special treatment because she was a former commissioner.

Satterlee also appeared to have been less than direct about her employment arrangements. Both Hanson and Adams, who saw Commissioner Satterlee at the NARUC Convention in November of 1983, testified they were not aware that she was working for NWB at the time. Furthermore, Satterlee initially misrepresented to newspaper reporters the date she started working as a consultant with NWB. As with Hanson, these circumstances have raised questions about the legitimacy of the NWB/Satterlee consulting arrangement.

The Department recognizes Satterlee and Hanson each had qualifications for the jobs they were offered by NWB. Satterlee was hired in large part due to her duly-earned reputation as a consumer advocate both while on the Commission and prior to that. Hanson had operated a small business for years, served in the legislature, and while on the Commission had been, among other things, an advocate for small telephone companies. Both actually took some time in coming to agreements with NWB as to exactly what they would do.

Both Satterlee and Hanson actually engaged in consulting activities on behalf of NWB. Satterlee produced invoices and generally described the work she did for NWB. Hanson kept detailed logs of the trips to St. Paul and the phone calls he made as part of his consulting work. NWB's payments to Satterlee and Hanson were for work either actually done or, as in Hanson's case, anticipated.

Nevertheless, these consulting arrangements created an appearance of a conflict of interest which has jeopardized the public trust in the Commission's impartiality. The above facts demonstrate that that one-year ban on employment of commissioners by regulated utilities which the legislature recently passed and the Governor signed into law, Minn. Stat. § 216B.036(a)(1986), is necessary to assure the public trust in the regulatory process. Similarly, the legislative ban against employing persons on the Commission who worked for a regulated utility in the prior year will further safeguard the integrity of regulatory proceedings. Minn. Stat. § 216B.035(b)(1986).

The principle question, however, for the Department to address in this report is whether the administrative process has been harmed, and if so, identify for administrative remedy those cases which have been affected by the negotiations which took place while the Commissioners were adjudicating cases before them on the Commission. The next section of this report addresses this issue.

B. Whether the Commissioners' Employment Negotiations Should Have Disqualified Them From Considering Issues Before the Commission, and, If So, What Remedies Are Available.

The Department has identified several Commission decisions which require Commission review because of employment negotia-

tions between regulated utilities and Satterlee or Adams. The decisions are: the NWB Basic Six decision (P421/M-83-144 and P421/M-83-167); the NWB Rate Case, 82-203; the Resale of Measured and Full-time WATS service (P421/CI-82-619 and P421/M-83-127); the United Telephone rate case reconsideration (P430/GR-84-597); Peoples Natural Gas docket (G011/PA-85-681); and the Competition Docket (P442, P443, P444, P421, P433/NA-84-212). In addition, the Department has also examined the New Ulm Toll Project case (P419/NA-84-331) to determine whether Hanson's prior employment with NWB affected the Commission's decision in that case. For reasons explained below, the Department does not recommend any actions in the NWB 82-203 rate case or the Peoples Natural Gas case. The Department recommends reconsideration of the Competition Docket, the WATS Resale orders, and the United and New Ulm Toll cases. Dismissal is recommended for Basic Six.

1. Legal Standards

The due process requirement that decision-makers must be impartial applies to those in administrative agencies who act as adjudicators as well as to judges in courts. *Withrow v. Larkin,* 421 U.S. 35 (1975); *Gibson v. Berryhill,* 411 U.S. 564 (1973). The high court has ruled that even an indirect pecuniary interest in a case mandates disqualification of the factfinder. *Ward v. Village of Monroeville,* 409 U.S. 5.7 (1972). Thus, the fairness of decisions made by the Commission while individual commissioners were discussing employment with affected utilities must be questioned.

A recently decided federal case illustrates how seriously employment negotiations can affect the impartiality of a decision-maker. In *Pepsico, Inc. v. McMillen,* 764 F.2d 458 (7th Cir. 1985), the Court of Appeals ordered the district judge to recuse himself because a person acting on behalf of the judge had contacted the law firms of both parties involved in the case to inquire about future employment for the judge. These inquiries were made without the judge's knowledge and both law firms replied that they were not interested in hiring him. The court noted that because one firm had firmly rejected the judge, and the other had not, an objective observer might wonder whether the judge would at some uncon-

scious level favor the firm that had not definitely rejected him. The court stated that a judge could not consider a case in which he has negotiated "albeit preliminary, tentative, indirect, unintentional, and ultimately unsuccessful" with a party in the case over his future employment. The appearance of equal justice, the dignity and independence of the judiciary and the confidence of the public all require recusal in such case. *Id.* at 461.

The Supreme Court has held that most of the law concerning disqualification because of self-interest applies with equal force to administrative adjudicators. *Gibson v. Berryhill, supra,* 411 U.S. at 579. Thus, the same standards should be applied to the Commissioners who were negotiating employment as was applied to the judge in *Pepsico.* Such negotiations jeopardized the ability of the Commission to fairly adjudicate the issues before it and the affected members should have disqualified themselves. As the Commission stated in *In the Matter of the Petition of Northern States Power Co.,* GOO2/GR-85-108 (*NSP*):

> few contacts between a utility and a government official are so egregious as the promise of employment at a time when the official is being asked to rule on matters of consequence to the utility.

NSP at 8.

In the *NSP* case the Commission articulated three possible administrative responses to improper communications with a decision-maker:

> 1. No remedial action is required where the ex parte contacts do not significantly taint the decision or cause procedural unfairness.
> 2. Agency proceedings that have been blemished by ex parte communications are voidable and reconsideration of the decision is the proper remedy.
> 3. Improper ex parte communications which so irrevocably taint the agency's decision-making process may render the agency decision void *ab initio* and the case must be dismissed or judgment rendered against the violating party.

NSP at 6–7.

In determining the appropriate agency response to ex parte communications, the Commission in *NSP* further articulated five considerations to assess whether a particular decision must be voided and the case dismissed. If less than five of these considerations are met, it may be appropriate for the Commission to either take no action or reconsider the tainted decision. These five considerations are:

1. The gravity of the ex parte communications;
2. Whether the contacts may have influenced the agency's ultimate decision;
3. Whether the party making the improper contacts benefited from the agency's ultimate decision;
4. Whether the contents of the communications were unknown to opposing parties, who therefore had no opportunity to respond; and
5. Whether vacation of the agency's decision would serve a useful purpose.

NSP at 7.

The expiration of the reconsideration period does not bar Commission action on past decisions it determines to be tainted. It is well established that administrative agencies have an inherent authority to reconsider their own decisions, since the power to decide the facts in the first instance carries with it the power to reconsider. *E.g. Trujillo v. General Electric Co.*, 621 E2d 1084, 1087 (10th Cir. 1980); *United States v. Sioux Tribe*, 616 F.2d 485, 493 (Cl. Ct. 1980) (and cases cited therein), *Anchor Casualty Co. v. Bongards Coop. Cream Ass'n.*, 253 Minn. 101, 91 N.W. 2d 122, 126, (1958). An administrative agency may reopen a case at any time as long as proper notice is given and the right is exercised within a reasonable time period. *Dawson v. Merit Systems Protection Board*, 712 F.2d 264, 267 (7th Cir. 1983). *Stearns-Hotzfield v. Farmers Ins. Exchange*, 360 N.W. 2d 384, 389 (Minn. App. 1985).

Reopening the Commission decisions at issue here would be within a reasonable time because the Department and the Commission have only recently discovered that these regulated utilities were discussing employment opportunities with sitting commissioners at the time of the decisions. Contentions of bias should be raised as soon as practical after a party has reasonable cause to believe that

grounds for disqualifications exist. *Capitol Transp., Inc. v. United States*, 621 F.2d 1312, 1325 (1st Cir. 1979). Since the Department has only recently uncovered the evidence of bias, its recommendation to reopen the affected dockets is timely.

The Minnesota Supreme Court has stated that an administrative agency should use its power to reopen:

> To serve the ends of essential justice and the policy of the law. . . . [T]he denial to such tribunals of the authority to correct error and injustice and to revise its judgments for good and sufficient cause would run counter to the public interest. . . . [T]he power of correction and revision, the better to serve the statutory policy, is of the very nature of such governmental agencies. *Anchor Casualty Co. v. Bongards Co-op. Cream Ass'n, supra* 91 N.W. 2d at 126.

Thus, the Commission must now reexamine decisions which employment discussions tainted; and, applying the *NSP* criteria, determine the appropriate action.

2. The Commission Decisions Affected by Negotiations

The Department has reviewed the significant decisions of the Commission for the time periods when Commissioners Hanson, Adams and Satterlee were discussing employment prospects with utilities or had been recently employed as a consultant for a company. Ex. 15. Based on this review, the Department identified seven decisions which may have been tainted. In each instance the Department recommends either no futher action, reconsideration, or vacation of an existing order and dismissal.

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C. Whether the Frequent Contacts Between NWB and Individual Commissioners Through Meals Sponsored by NWB Violated State Law or Commission Policy.

It appears a goal of NWB's free meals and regular contacts was to promote a regulatory environment favorable to the company. Weir testified he saw his job as selling the company while Madison

said Weir provided the meals in order to open "communications paths." It is unlikely that a commissioner could be bribed with free lunches or dinners. At the same time, it is only human for a commissioner to positively view a company whose employee she or he dines with on a regular basis at the company's expense.

The former commissioners and Weir testified that there were no improper ex parte contacts during the frequent meals they had at NWB's expense. Moreover, none of the participants felt there was anything inappropriate in NWB's contacts with commissioners at these frequent meals. Weir stated that a thousand dollars worth of meals to a commissioner is not of significant value nor in his opinion did it appear improper. W-257. Although it is unclear whether these sorts of contacts violated state law, these frequent meals, particularly when the Commission was deliberating issues of interest to NWB, have an appearance of impropriety and should be avoided.

Generally, the cost of meals, even meals over long periods of time, could not be said to be a significant portion of a commissioner's income. However during the periods examined the frequent meals provided by NWB to Commissioners Hanson, Satterlee and Adams approach the level of significant portion of their incomes ranging from approximately 1.4% to 4.3% of the commissioners' salaries. According to Weir's records, Hanson received $870 in meals for the 19-month period in 1982, 1983, and 1984 for which the Department has records. Commissioner Adams received approximately $2,700 in meals for the same period as Hanson. Finally, Weir's records reflect that NWB expended approximately $500 in meals and gifts for Satterlee from November, 1982 to July, 1983. Satterlee however disputes some of these expenditures.

The conflict of interest provisions of Minn. Stat. § 216A.035 and 10A.07, for these time periods, do not appear to prohibit these meals. The conflict of interest provision which governed the Commission during these time periods prohibited commissioners from receiving any significant portion of their income "directly or indirectly" from "any public utility." Minn. Stat. § 216A.035. A reading of the legislative history of this statute indicates that the preceding quoted language was enacted as part of the Public Utilities Act of 1974. The reference to "public utility" refers to gas and electric utilities, not telephone companies. *See* Minn. Laws 1974, Chap. 429, Sec. 2. Moreover, the penalty provisions of Minn. Stat. § 216A.035

and enforced against gas and electric utilities under Minn. Stat. §§ 216B.57-216B.61 are lacking under Minn. Stat. Chapter 237. Thus, the prohibition against a commissioner from indirectly receiving income under this section does not encompass telephone companies which are defined and regulated under Chapter 237. This interpretation is substantiated by a recent 1986 amendment to Minn. Stat. § 237. 075 which expands the coverage of this statute to prohibit a commissioner from receiving a significant portion of income directly or indirectly from any public utility "or other organization subject to regulation by the commission." Minn. Laws 1986, Chap. 409, Sec. 3.

Regardless of the language of this statute the Department believes that it was inappropriate and harmed the public trust for these three commissioners to frequently accept meals from NWB even though the law, for the period investigated, did not clearly preclude such activity in the case of a telephone company. The rationale for endorsing a strict conflict of interest standard for gas and electric utilities should apply with equal force and effect to regulated telephone companies.

Second, Minn. Stat. § 10A.07, governing conflicts of interest for all public officials, is not applicable. This statute only applied when those officials make a decision which would "substantially affect" his or her "financial interests." "Financial interests" is defined under Minn. Rules 4515.0100, subp. 5, as: "Any asset owned or controlled by an individual or business which has the potential to produce a monetary return." Meals, even frequent meals, are not assets which have "the potential to produce a monetary return" as required by this rule.

On the other hand, the Code of Ethics for Employees in the Executive Branch, Minn. Stat. § 43A.38, subd. 2, directly prohibits the acceptance of meals by state employees in the executive branch. Executive Branch employees may not accept, in the course of or in relation to their official duties, "any payment of expense, compensation, gift, gratuity, favor, service or promise of future employment or future benefit from any source except the state for any activity related to the duties of the employee unless otherwise provided by law." The acceptance of reimbursement expenses for meals is permissible if approved in advance by the appointing authority, Minn. Stat. 438A.38, Subd. 2(e). The statute directs the appointing

authority to report in writing to the legislative auditor when there is probable cause to believe that a substantial violation has occurred. Minn. Stat. §43A.39, subd. 2.

It is unclear whether Minn. Stat. §§43A.38 and 43A.39 apply to commissioners and other heads of agencies. Although the statute could be read to include agency heads such as commissioners in its definition of employee, the Department of Employee Relations (DOER), which administers these statutory sections, has consistently taken the position that this statute does not cover heads of agencies. DOER's interpretation is based on the distinction drawn between heads of agencies and employees of those agency heads in the definition section of the statute. Minn. Stat. §43A.02. In addition, because the commissioner of employee relations administers this section, DOER considers it unlikely that the legislature intended one commissioner in the cabinet to have reassignment authority over his or her peers. Ex. 75.

Nevertheless, Commission Counsel periodically reminded both the Commissioners and Commission Staff that Minnesota Statutes and Rules prohibited employees from accepting expenses paid without prior approval. In a memorandum dated September 26, 1983, Commission Counsel called the Commissioners' attention to Minn. Stat. 43A.38 and advised them to direct further questions to himself or DOER. Commissioners Adams and Hanson were specifically addressed on the memorandum. Ex. 74.

Regardless of whether the former commissioners' acceptance violated Minn. Stat. § 43A.38, these commissioners were clearly on notice that allowing regulated utilities to pay their expenses was regarded as improper. In 1977, the Governor issued an executive order establishing a code of conduct for officials and employees of the executive branch. Ex. 73. That order prohibited officials from receiving any compensation, reward or gift for greater than $5.00 for any matter related to state government employment. While this order was not in effect for the period covered by the report, commissioners who served at the time it was in effect should have been on notice of the impropriety of accepting frequent meals from utilities.

Memoranda written to Commission Staff on September 3, 1980, Ex. 81; September 25, 1980, Ex. 82; and January 23, 1981, Ex. 83 also reminded the Commission and staff of the impropriety of

accepting meals from regulated utilities. In a memo dated January 23, 1981, the Commission Staff Director notified all staff that the Commission had directed him to establish an agency policy regarding the ethics rules. He ordered the staff not to accept any meals, travel expenses or conference fees from regulated companies. Any exceptions were to be specifically approved on a case by case basis after notification of the Commission.

The memo clearly stated the reasons for such a policy:

> First, it eliminates any real or false impressions of improprieties on the part of the staff. As much damage can be done to the Commission's effectiveness by false impressions of improprieties as actual improprieties. Secondly, a uniform policy will eliminate any uncertainty the staff may have as to what is allowable and what is not allowable. This uncertainty can lead to confusion, misunderstanding, and even dissen(s)ion among the staff. Thirdly, an established policy will give both staff an the regulated utilities a clear line of demarcation. This will eliminate that uncomfortable situation for both staff and the utility when a decision has to be made on a case by case basis by the individual staff person involved.

Commissioners Satterlee, Hanson and Adams were on the Commission in early 1981 when the Commission ethics policy was adopted for the staff. They apparently did not apply the directive to themselves. The Commission policy was specifically directed at staff members and thus covered the conduct of Richard McMillen until he joined NWB in November of 1984. The records maintained by Weir indicate that McMillen did not follow the Commission policy on acceptance of meals during the time he was on the Commission staff.

As a body vested with the execution fo the public trust, commissioners should attempt to avoid even the appearance of impropriety. The Department believes that the pattern of contacts of regular acceptance of meals from one of the companies regulated by the Commission does create an appearance of impropriety. A proper analogy would be discovering that the judge deciding a court case in which you have been involved has lunch paid for by your opponent on a regular basis. Making such a discovery would

inevitably raise the question of whether or not the final decision was fair.

The timing of these meals and important actions by the Commission increases the appearance of impropriety. Weir and the former commissioners stated that they never discussed the merits of contested cases at these meetings and thus no improper ex parte contacts occurred. Even if matters before the Commission were not discussed, however, the frequency of contacts between commissioners and Weir at a time when matters of importance to NWB were being considered increases the appearance of impropriety and further jeopardizes the public trust.

A close examination of the timing of the commissioners' meals with Weir during important decisons on the 83-600 case illustrates this point. On June 2, 1984, Weir took Adams who was then Chairman of the Commission, out for a meal at NWB's expense. On June 5 the Commission heard oral argument on a motion to dismiss NWB's application for a rate increase. The next day Weir again hosted a meal for Adams and Hanson at NWB's expense. The following day, June 7, Hanson wrote a memo to the other commissioners recommending the motion to dismiss NWB's rate request denied. The following day, June 8, Weir, Adams and Hanson again dined at NWB's expense.

The same pattern is found during the time when the Commission was deliberating the merits of the 83-600 case in July, 1984. On July 3, 1984, Weir hosted Adams at a meal. Two days later, July 5, the Commission received a staff briefing on the issues in the NWB's 83-600 rate case. On July 6, while the staff briefing continued, Weir took Adams out for one meal and Hanson out for another meal. On July 9 through 13, the Commission deliberated the 83-600 case. On July 11, Weir, Hanson and Adams went out for a meal at NWB's expense.

Thus, two commissioners had meals paid for by an NWB representative at NWB's expense on the second day of staff briefings about a highly contested rate case and again part way through the Commission deliberations. While the participants state they did not discuss the merits of any contested case, the appearance and timing inevitably raises the questions which the Commission sought to avoid in its 1981 directive to its own staff.

The Department's purpose in undertaking this investigation was

not to recommend action against individual commissioners for arguable violations of the law. Rather, the Department's purpose in reporting the three commissioners' pattern of contact with NWB is to identify areas where improper conduct may jeopardize the commission's adjudicatory role and suggest measures to eliminate such conduct in the the future.

In the code of ethics adopted by the Commission on February 6, 1986, the Commission banned the acceptance of any meals or other gifts from regulated companies. The Department lauds that action. Adoption of the code of conduct makes it clear to both commissioners and to the regulated industries that the Commission seriously seeks to avoid even the appearance of impropriety in the conduct of public affairs.

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III. RECOMMENDATIONS OF THE DEPARTMENT OF PUBLIC SERVICE

The Department believes that employment negotiations such as those with Satterlee and Adams can create an expectation, a hope for future reward, which impairs the objectivity of a neutral decision-maker. Previous employment with such as with Hanson likewise can impair the objectivity of a decision-maker. At a minimum commissioners should disclose potential conflicts to their colleagues and recuse themselves from any disputed decisions involving the companies they have worked for or they hope to work for in the future. The numerous contacts over free meals between NWB and the three commissioners, while perhaps not directly impacting particular decision, could nevertheless help create an environment that is favorable to a regulated company.

To remedy the problems which have come to light in the course of this investigation, the Department makes the following recommendations:

1. The Commission should reconsider its May 4, 1983 decision on resale of WATS services.
2. The Commission should dismiss its decision setting the price of the NWB Basic Six sets (M-83-144) and issue a show cause order to NWB to justify the sale prices charged.

3. The Commission should vacate its order Denying Reconsideration, dismiss the pleadings without prejudice and permit the parties who originally filed petitions for reconsideration to refile such petitions in the United 84-597 rate case.
4. The Commission should reconsider its October 15, 1985 order in the Competition Docket (NA-83-212) to insure that the final order was consistent with the Commission's deliberation votes. The case should be redeliberated if inconsistencies appear.
5. The Commission should vacate its final order and reconsider the New Ulm Toll case (NA-84-334).
6. The Commission should continue in its efforts to adopt formal rules based on its Code of Conduct, outlining the responsibilities of the commissioners and regulated companies as to contacts, particularly during times of deliberation, and the acceptance of meals and other gifts.
7. The Commission should join with the Department in proposing legislation to apply the same penalties to telephone companies who directly or indirectly give a commissioner a significant portion of income as now apply to gas and electric utilities.
8. The Commission should adopt a formal rule setting forth the basis upon which a commissioner should recuse himself or herself from a decision when there may be a conflict of interest.
9. The Commission should order NWB to present a plan for internal audits to assure that its contractual arrangements with consultants are set out in specific detail and that safeguards are used to insure that one type of expense, such as legislative, is not coded as something else, such as legal. Further, the Commission should order an investigation into NWB's contracting procedures and arrangements with law firms and consultants.
10. The Commission should order NWB and NSP to deliver to the Department and the Commission copies of their independent internal investigative reports.

APPENDIX 6

Evan J. HENRY,

Respondent,

v.

MINNESOTA PUBLIC UTILITES COMMISSION,

Petitioner-Appellant.

No. C9-84-1950.

Supreme Court of Minnesota.

Aug. 8, 1986.

Rehearing Denied Sept. 11, 1986.

Northwestern Bell Telephone Company and the Minnesota Public Utilties Commission (MPUC) appeal a decision of the court of appeals reversing an order of the MPUC granting Northwestern Bell a $57 million dollar annual rate increase. The MPUC convened a rehearing and took additional evidence in a rate case brought by Northwestern Bell after the 10-month period for completion of such a case under Minn.Stat. § 237.075, subd. 2 (1984) had elapsed. Evan Henry, an intervenor, appealed the MPUC's final order and adjusted final order in the case, alleging, among other claims, that these orders were based on improper procedure. The court of appeals reversed, holding the MPUC had circumvented the 10-month statutory period and that the rehearing was required to be convened as a contested case proceeding. We reverse the decision of the court of appeals on these issues and otherwise affirm. We reinstate the final order and adjusted final order of the MPUC.

The factual background of this case is complex. Northwestern Bell filed a petition with the MPUC on September 19, 1983 seeking a $109 million dollar annual rate increase and a modification of its rate structure. The MPUC suspended the proposed rate schedule and initiated a contested case proceeding. A lengthy series of hearings on the petition were held before an ALJ at locations throughout the state in January-April 1984.

While these hearings were in progress, Northwestern Bell was

planning an extensive corporate reorganization. In January 1984, the company filed a corporate restructuring plan with the Federal Communications Commission. Copies of these filings were presented to the MPUC on April 26, 1984, at which time Northwestern Bell notified the commission that, as of April 30, 1984, it would incorporate a new holding company. The holding company would have as its wholly-owned subsidiary a telephone services operating company, Northwestern Bell Telephone Company, who became the petitioner in the pending rate case.

The timing of the company's notice of restructuring limited the ability of the ALJ and the MPUC to respond to the new information within the context of the pending rate case. Hearings on the petition had already been completed and the MPUC was required to issue its final determination by July 30, 1984 to meet the time limit imposed by Minn.Stat. § 237.075, subd. 2 (1984). Subdivision 2 establishes a 10-month period during which a utility's proposed rates may be suspended following a petition for rate change. If the MPUC does not make a final determination concerning a schedule of rates within 10 months after the petition is filed, the rate schedule proposed by the utility is deemed approved. *Id.*

The ALJ called a post-hearing conference of all parties on May 14, 1984, to determine if the present record in the case adequately reflected the financial effect of the corporate reorganization. Following the conference, motions to dismiss Northwestern Bell's petition were filed with the ALJ by several intervenor parties, including Evan Henry, the respondent before this court, and the Department of Public Service (DPS). The MPUC, for its part, responded to the notice of reorganization by ordering the DPS to investigate the financial effect of the corporate restructuring on the pending rate petition.[1] Subsequently, Northwestern Bell entered into a stipulation with the DPS, agreeing that the effect of the reorganization should be considered in the evidentiary record of the rate proceeding and agreeing not to contest the DPS' recommendations to the MPUC as to the amount of any rate adjustment needed to account for the

[1] Minn.Stat. § 237.081, subd. 1 (1984) provides the MPUC may, on its own motion, summarily investigate any matter relating to any service it believes "for any reason" should be examined. If, after making such summary investigation, the MPUC is satisfied there are sufficient grounds to warrant a formal hearing on the matters investigated, it may initiate such a hearing. Minn.Stat. § 237.081, subd. 2 (1984).

the financial effect of the corporate reorganization. The DPS thereafter withdrew its motion to dismiss.

Before the DPS investigation was concluded and its report submitted, however, the ALJ recommended to the MPUC that the rate petition be dismissed. In the considered opinion of the ALJ, the financial effect of the corporate reorganization was likely to be substantial and had to be considered before any decision on the rate petition could be made. The ALJ stated he did not have sufficient time to hold hearings on the reorganization before the 10-month statutory period expired. He concluded that Northwestern Bell, by failing to introduce sufficient evidence into the present record on which a final determination could be reached, had not met is statutory burden of proof and he recommended the rate petition be dismissed on this ground.

The MPUC, on receiving this recommendation, informed the ALJ that it had decided to address the restructuring issue within the context of the pending proceeding. The commissison stated it would render a decision on the present record within the 10-month period and then, on its own motion, reopen the proceeding for hearings on the restructuring issue. The ALJ was asked to submit recommendations on the substantive issues in the rate case, excluding consideration of the effect of the corporate restructing. The ALJ thereafter submitted a second report, recommending that Northwestern Bell be awarded $57,511,000 in increased annual revenues and that a new rate structure be imposed. Based on these recommendations, the MPUC issued a final determination in the rate case on July 27, 1984, authorizing the recommended rate increase and adopting the recommended rate structure. The July 27, 1984 final order was issued within the required 10-month period.

The DPS submitted its report to the MPUC on the financial effect of the corporate restructuring on August 1, 1984, recommending a downward adjustment of $371,000 to the rate increase previously ordered. Shortly thereafter, this figure was revised to $363,000. The MPUC, on its own motion, ordered a rehearing and a reopening of the record for the purpose of receiving into evidence the DPS report and to determine if a further evidentiary hearing and separate contested case proceeding regarding the financial effect of the corporate restructuring were required. At the rehearing, no party objected to the amount of the DPS' proposed adjustment.

Evan Henry objected to the rehearing procedure, alleging the MPUC did not have authority to reopen the proceeding after it had issued a final determination. He renewed his motion to dismiss the petition and the MPUC denied the motion. An adjusted final order incorporting the downward adjustment was issued by the MPUC on September 26, 1984, almost 12 months after the rate petition had been filed. This appeal followed and Henry prevailed before the court of appeals.

The MPUC and Northwestern Bell raise four issues before this court:

1. Did the MPUC act within its statutory authority under Minn. Stat. §237.075, subd. 2 (1984) in ordering a rehearing after reaching a final determination?

2. Was the MPUC required by either Minn.Stat. § 237.075, subd. 2 (1984) or Minn.Rules pt. 1400.8300 (1985) to consider the issue of Northwestern Bell's corporate reorganization in a contested case procedure and did the summary procedure adopted for the rehearing in this case violate Henry's constitutional right to due process?

3. Did the composition of the MPUC who heard this case satisfy the requirements of Minn.Stat. § 216A.03 (1984)?

4. Did Northwestern Bell meet its burden of proof under Minn. Stat. § 237.075, subd. 4 (1984) as to the rate increase awarded?

I.

The MPUC and Northwestern Bell seek reinstatement of the July 27, 1984 final order and the September 26, 1984 adjusted final order of the MPUC. The court of appeals reversed the orders as based on improper procedure in that the MPUC did not have statutory authority to order a rehearing after reaching a final determination in a rate case. An agency determination based upon unlawful procedure or affected by an error of law will be overturned if the substantial rights of the person challenging that determination have been thereby prejudiced. Minn.Stat. § 14.69 (1984).

Minn.Stat. § 237.075, subd. 2 (1984) provides that after a petition for a rate change has been filed, the MPUC may, while considering the petition, suspend the proposed rates, but not for a longer period than 10 months. If the commission does not make a final determination concerning a schedule of rates within 10 months

after the initial filing date, the utility's proposed schedule is "deemed to have been approved." *Id.* Subdivision 2 further provides, however, that the MPUC may convene a rehearing and that this rehearing will, in effect, toll the 10-month time limit:

> For the purposes of this section, 'final determination' means the initial decision of the commission and not any order which my be entered by the commission in response to a petition for rehearing or other futher relief. The commission may further suspend rates until it determines all those petitions.

Id. No one disputes in this appeal that the quoted language of subdivision 2 gives the MPUC the power to order a rehearing or provide further relief after it has reached a final determination. The heart of the parties' dispute concerns the circumstances under which it is proper for the MPUC to use its rehearing power.

The MPUC, while recognizing that the effect of the corporate reorganization had to be considered as part of any decision on the rate petition, issued a final determination in the case within the 10-month period based on a record that did not consider the issue. The commission then convened a rehearing on its own motion to receive evidence on this issue into the record and issued an adjusted final determination based on this augmented record. The court of appeals concluded this use of the MPUC's rehearing power was improper as an effort to "circumvent the 10-month statutory limitation." This effort, the court of appeals stated, "must fail as a sham." *Henry v. Public Utilities Commission,* 376 N.W.2d 226, 231 (Minn. Ct.App.1985). Further, the court of appeals reasoned, this use of the rehearing power was improper because it "ignore[d] the role of a rehearing in an administrative procedure," which is to serve the purpose of error-correction. *Id.*

We reject, first of all, this interpretation of the legal effect of subdivision 2's provision for a 10-month rate suspension period. The statutory time limit refers only to the period during which rates may be suspended and is not a temporal limit on the MPUC's jurisdiction, as the court of appeals seemed to conclude. The clear purpose of the provision is to protect utilities from the potentially confiscatory effect of regulatory delay. In other cases where we have

interpreted similar statutory time limits, we have construed these provisions as directory and not mandatory, stating the time limit "define[s] the time and mode in which public officers shall discharge their duties, and ****** [is] obviously designed merely to secure order, uniformity, system, and dispatch in the public business." *Heller v. Wolner*, 269 N.W.2d 31, 33 (Minn.1978) (citation omitted). Consistent with these cases, we conclude subdivision 2 does not deprive the MPUC of jurisdiction to issue a decision in a rate proceeding if it fails to reach a decision within the 10-month suspension period.

We are also not persuaded that by convening the rehearing on its own motion in this case, the MPUC abused the poper purpose of a rehearing in administrative procedure. The statutes that govern the MPUC's proceedings give the commission authority "to hold hearings and make determinations upon its own motion to the same extent, and in every instance, in which it may do so upon petition." Minn. Stat. § 216A.05, subd. 5, (1984). This rate case proceeding, one of the largest and most complex in the MPUC's history, had required a great deal of time, money and effort from many parties. The commission estimated that the alternative to the rehearing procedure it adopted, dismissal of the rate case, would have resulted in costs of two to three million dollars, costs which were likely to be borne by Northwestern Bell's rate payers. The proceeding had produced a substantial record on a whole range of issues, many of which were not affected by the corporate reorganization. We therefore conclude the MPUC's decision to order a rehearing after a final determination is this case was lawful, practical, and served the public interest.

We hold the MPUC acted in this case within its statutory authority under Minn.Stat. § 237.075, subd. 2 (1984) in ordering a rehearing after reaching a final determination. The decision of the court of appeals to the contrary is reversed.

II.

The court of appeals also based its decision on the ground that the MPUC was required by subdivision 2 and Minn.Rules pt. 1400.8300 (1985) to consider the issue of Northwestern Bell's corporate reorganization in a contested case proceeding rather than the summary rehearing procedure it adopted. *Henry*, 376 N.W.2d at

231-32. Henry also claims the rehearing was improper because its summary nature deprived him of constitutional due process.

An agency must initiate a contested case hearing when one is required by law. Minn.Stat. § 14.57 (1984). Subdivision 2 requires a contested case hearing when the MPUC determines that a "significant issue" of the reasonableness of the rates requested by a utility cannot be resolved to the satisfaction of the commission. Minn. Stat. § 237.075, subd. 2 (1984).

The MPUC convened a rehearing in this case for the purpose of receiving into evidence the DPS report on the financial effect of Northwestern Bell's corporate reorganization on the ordered rate increase for determining whether there was cause to hold further evidentiary hearings in the form of a contested case proceeding on the matter. Before the hearing, a copy of the DPS report was served on all parties, including Henry, and comments were invited. At the hearing, which Henry attended, the MPUC again solicited testimony or comment on either the report or the restructuring issue. Henry did not object to the report either before or at the hearing, nor did he request a contested case hearing at either of these times. In his brief to this court, Henry claims he approached an [sic] MPUC commissioner immediately after the rehearing was adjourned and asked for an opporuntity to question the DPS on its report. He renewed this request in a letter four days later. By order dated September 26, 1984, the MPUC adjusted the rate increase downward and ruled that further hearings were not required on the issue of reorganization.

We infer from its action that the MPUC concluded the issue of reorganization was not an unresolved issue and we find this a reasonable conclusion. The DPS had reported that the financial effect of the reorganization could be accounted for by a minor downward adjustment in the rate increase ordered, an adjustment to which Northwestern Bell had previously stipulated. All parties to the rate proceeding were given ample notice and opportunity to challenge this proposed resolution of the issue and none did, including Henry. Given this apparent consensus, the MPUC could conclude there was no dispute over the matter. Thus, under the standards of subdivision 2, there was no "unresolved" issue requiring a contested case hearing.

Nor does Minn.Rule pt. 1400.8300 (1985) require a contested case

procedure in this case. The rule provides that a rehearing shall be conducted "in the same manner prescribed for a hearing." *Id.* This means that the standards contained in subdivision 2 for ordering a contested case proceeding should be applied whether the proceeding at issue is an original proceeding or a rehearing. We have already concluded the statute did not require this rehearing to be convened as a contested case proceeding.

Finally, we do not agree that the summary procedure the MPUC adopted for the rehearing deprived Henry of due process as guaranteed by our state and federal constitutions. He, like all other parties, received fair notice and opportunity to make his views known. He was given notice and several opportunities to question the DPS report or to request further evidentiary hearings on the matter and he did not avail himself of these chances. Inexplicably, he attempted to participate in any hearings on the matter and to question the DPS only *after* the hearing had been adjourned. This request was not a timely or reasonable effort to participate and the MPUC's failure to respond to the request did not violate fundamental fairness or due process. We hold the MPUC was not required by Minn.Stat. § 237.075, subd. 2 (1984) or Minn.Rules pt. 1400.8300 (1985) to consider the issue of Northwestern Bell's corporate reorganization in a contested case proceeding. We further hold the summary procedure adopted for the rehearing in this case did not deprive Henry of constitutional due process.

III.

Henry claimed before the court of appeals that the MPUC members who decided this case lacked the qualifications required by Minn.Stat. § 216A.03 (1984). This challenge was rejected on the ground that a court is not the appropriate forum in which to consider the qualifications of commissioners under the statute. We agree. Section 216A.03 directs that members of the MPUC shall be appointed by the governor with the advice and consent of the senate. In selecting members, the governor is directed to give consideration to "persons learned in the law or persons who have engaged in the profession of engineering, public accounting or property and utility valuation as well as being representative of the general public." *Id.* In enacting this statute, the legislature has suggested that the governor "consider" persons with certain professional expertise when appointing members, but the governor's authority if

not constrained by the law and no legal duty regarding the qualifications of those appointed is thereby created that we can enforce. We affirm the decision of the court of appeals on this issue and we hold this court is not an appropriate forum in which to challenge the qualifications under Minn.Stat. § 216A.03 (1984) of the MPUC commissioners who heard this case.

IV.

Henry's final claim is that Northwestern Bell did not meet its statutory burden of proof as to the rate increase ordered. Telephone service rates are to be fair and reasonable. Minn.Stat. § 237.06 (1984). A telephone company petitioning for a rate change bears the burden of proving the rate change it proposes is "just and reasonable." Minn.Stat. § 237.075, subd. 4 (1984). If, after hearings, the MPUC finds the proposed rates are unjust, unreasonable or discriminatory, the commission shall determine the rates to be charged. Minn.Stat. § 237.075, subd. 5 (1984).

We will review the MPUC's determination of a just and reasonable rate in this case according to the substantial evidence standard for rate of return determinations and the arbitrary and capricious standard for rate design determinations. *Hibbing Taconite Co. v. Public Service Commission,* 302 N.W.2d 5, 9 (Minn.1980). Based on our careful review of the evidence in the record of this case and the 100-page order of the MPUC, we conclude the decision of the MPUC was supported by evidence in the record and was not arbitrary and capricious. We therefore hold Northwestern Bell met its statutory burden of proof under Minn.Stat. § 237.075, subd. 4 (1984) as to the rate increase ordered.

Revered in part; affirmed in part. The July 27, 1984 and September 26, 1984 orders of the MPUC are reinstated.

APPENDIX 7

OFFICE - NOVEMBER 7, 1986

The Commission met on November 7, 1986 with Chair Crump and Commissioners Beerhalter, Kitlinski, O'Keefe and Peterson present.

The following items were adopted by the Commission.

U-999/CI-86-177
Investigation of the Nature and Extent of Contacts between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners

Commissioner O'Keefe moved to reject the petitions to reopen the following four dockets: *Instrastate Intercity Telecommunications Services (Toll Competition),* Dockets No. P-442 et al/NA-84-212; *United Telephone Company,* Docket No. P-430/GR-84-597; *Northwestern Bell Telephone Company,* Docket Nos. P-421/CI-82-619, P-421/M-83-127 and P-421/M-80-306 (WATS Resale), and *Northwestern Bell Telephone Company,* Docket Nos. P-421/M-83-144, P-421/M-83-167, P-421/M-82-473, P-421/M-82-476, P-421/M-4-82-277 (Basic Six) and to affirm its decision not to reopen *New Ulm Telecom,* Docket No. P-419/NA-84-334.

The motion passed 4-0. Commissioner Kitlinski not present.

Commissioner O'Keefe moved to reject the motion of the Minnesota Public Interest Research Group (MPIRG) to dismiss the *Northwestern Bell Telephone Company,* Docket No. P-421/GR-83-600 (NWB 83-600) Findings of Fact, Conclusions of Law, and Order of July 27, 1984.

The motion passed 4-0. Commissioner Kitlinski not present.

Commissioner Crump moved to deny MPIRG's motion to reconsider the November 13, 1984 Order Denying Intervenor Compensation in *NWB 83-600.*

The motion passed 5-0.

Commissioner O'Keefe moved that it is reasonable to assume

that Northwestern Bell ratepayers have difficulty believing that their rates were arrived at in a fair and proper manner when two members of the commission that established the rates were wined and dined extensiveley by Northwestern Bell during the time that the rates were under consideration. A public perception of unfairness is certainly understandable and should be corrected. The lunches and dinner gave a NWB representative greater access to the two Commissioners in friendly surroundings than was enjoyed by other participants in the case and represented a serious abuse of the system.

The motion passed 5-0.

Commissioner O'Keefe moved to reconsider and redeliberate *NWB 83-600* and that to assure that current practices have been or are being updated to conform with the Commission's new Code of Conduct and Ex Parte rules, NWB shall file with the Commission a company code of conduct and updated expense reimbursement policy for contacts with the Commission and staff.

The motion passes 5-0.

There being no further business, the meeting was adjourned.

APPROVED BY THE COMMISSION
Harry Seymour Crump, Chair
Barbara Beerhalther, Commissioner
Cynthia A. Kitlinski, Commissioner
Robert J. O'Keefe, Commissioner
Darrel L. Peterson, Commissioner

APPENDIX 8

BEFORE THE MINNESOTA PUBLIC UTILITES COMMISSION

Barbara Beerhalter	Chair
Harry Seymour Crump	Commissioner
Cynthia A. Kitlinski	Commissioner
Robert J. O'Keefe	Commissioner
Darrel L. Peterson	Commissioner

ISSUE DATE: April 02, 1987

DOCKET No. U-999/CI-86-177

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners

Order After Investigation and Vacating July 27, 1984 Order in Docket No. P-421/GR-83-600
In the Matter of the Application of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota

***

On April 9, 1986, the Minnesota Public Utilities Commission (the Commission) issued its order Initiating Investigation in this docket. In that Order, the Commission directed the Minnesota Department of Public Service (DPS) to conduct an independent investigation to assess whether any improper communications occurred during Commission proceedings addressing issues of significant financial impact to regulated companies or addressing significant policy issues likely to lead to a significant financial impact on regulated companies.

The Commisssion directed that the investiagtion cover at least the last several months of the Commission terms of former Commissioners Juanita R. Satterlee, Roger L. Hanson, and Leo G. Adams. The Commission could then use this investigation to remedy any improper influence caused by these contacts.

On July 8, 1986, the DPS submitted its "Report of the Department of Public Service to the Minnesota Public Utilities Commission" (the DPS Report). The DPS also submitted the depositions and documents that it obtained in the course of its investigation as supporting exhibits to the DPS Report. The DPS identified seven decisions which may have been improperly influenced by employment discussions between regulated companies and then-sitting Commissioners and recommended that the Commission reopen the following five decisions: *Intrastate Intercity Telecommunications Services,* Docket No. P-442 et al/NA- 84-212 (October 15, 1985) (*Toll Competition*); *United Telephone Company,* Docket No. P-430/GR-84-597 (August 12, 1985) (*United*); *New Ulm Telecom,* Docket No. P-419/NA-84-334 (March 14, 1986) (*New Ulm*); *Northwestern Bell Telephone Company,* Docket Nos. P-421/C1-82-619, P-421/M-83-127, and P-421/M-82-512 (May 16, 1983) (*WATS Resale* docket); *Northwestern Bell Telephone Company,* Docket Nos. P-421/M-83-144, P-421/M-83-167, (June 1, 1983) (*Basic Six*). The DPS stated that no corrective action was necessary in *Northwestern Bell Telephone Company*, Docket No. P-421/GR-82-203 (April 20, 1983) or *In the Matter of the Acquisition of Peoples Natural Gas Company by Utilicorp United, Inc.*, Docket No. G-011/PA-85-681 (December 4, 1985). The DPS also made five other recommendations which related to actions to eliminate future improper contacts.

On August 13, 1986, Northwestern Bell Telephone Company (NWB) filed a response to the DPS Report, asking the Commission to deny the DPS recommendations to reopen the *WATS Resale, Basic Six, New Ulm,* and *Toll Competition* decisions.

On July 9, 1986, the Residential Utilities Division of the Office of the Attorney General (RUD-AG) filed a petition requesting the Commission to reopen and reconsider its July 27, 1984, Findings of Fact, Conclusions of Law, and Order in *Northwestern Bell Telephone Company,* Docket No. P-421/GR-83-600 *(NWB 83-600).* The petition claimed that this proceeding had been improperly in-

fluenced by ex parte communications between NWB and former Commissioners during deliberations on the case. The DPS Report had revealed these communications. On July 18, 1986, NWB filed its response asking the Commission to deny the RUD-AG petition. On August 1, 1986, the RUD-AG filed a reply brief to NWB's response. On September 15, 1986, NWB responded to the RUD-AG reply brief.

[sic] filed a petition requesting that the Commission vacate and dismiss its Juy 27, 1984 and November 13, 1984 Orders in *NWB 83-600* for reasons similar to those given by RUD-AG. On September 15, 1986, NWB responded to MPIRG's petition, asking that the petition be denied.

On October 3, 1986, the Commission isued[sic] its Order Establishing Procedures and Soliciting Briefs in this matter. That Order requested parties to submit briefs on whether *NWB 83-600, Toll Competition, United, New Ulm, WATS Resale, Basic Six* or any other decisions in the relevant time period were improperly influenced due to a conflict of interest or ex parte communications between former Commissioners Adams, Hanson or Satterlee and regualted companies. The Order requested that parties address the following questions in their briefs:

1. Were any of the decisions identified above affected by conflicts of interest or ex parte contacts?
2. Did any party seek to influence Commissioners or gain advantage in a case by employment discussions or other contacts with Commissioners?
3. Did any party successfully influence Commissioners' decisions by their contacts?
4. If any of the decisions were tainted by conflicts of interests or ex part contacts, what is the appropriate remedy in each instance?
5. Is the evidence contained in the DPS Report, depositions and exhibits sufficient for the Commission to resolve the questions posed above? If not, identify specific evidence challenged or to be introduced that a party believes is necessary for the Commission to resolve the questions.

The October 3, 1986 Order also required Northern States Power Company (NSP) and NWB to submit copies of their internal investigation reports to the Commission. On October 13, 1986 NSP filed

its internal investigation report.

On October 23, 1986, United Telephone Company (United), the Suburban Rate Authority (SRA), MPIRG, RUD-AG, NWB, and the DPS filed comments or briefs. In its brief, the DPS recommended that the Commission redeliberate *NWB 83-600* on the merits. The DPS had not recommended reopening this case in its July 8, 1986 Report which focused on the impact of job negotiations, rather than on gratuities and ex parte contacts. On October 24, 1986, the Minnesota Business Utility Users Council (MBUUC) filed a letter addressing this matter and U.S. Sprint filed a brief.

On October 28, 1986 the Commission issued its Notice of Oral Argument.

On November 3, 1986, NWB filed its Reply to the submissions of the other parties.

Oral argument was held on November 6, 1986, with representatives of the DPS, the RUD-AG, MPIRG, the SRA, the MBUUC, AT&T, and NWB participating.

SUMMARY OF ISSUES

I. Does the Commission have jurisdiction and legal authority to reopen prior rate proceedings?
II. Should the *NWB 83-600* docket be reopened?
III. Should the *Toll Competition* docket be reopened?
IV. Should the *United* docket be reopened?
V.. Should the *WATS Resale* docket be reopened?
VI. Should the *Basic Six* docket be reopened?
VII. Should the *New Ulm* docket be reopened?

FINDINGS AND CONCLUSIONS

I. The Commission's Authority to Act

The first issue the Commission must address in this proceeding is whether it has jurisdiction over these matters to correct any abuses that may have occurred due to a conflict on interest or ex parte comunications.

The Commission is aware that all of the matters addressed in this proceeding involve Orders that were issued at least a year or more ago. The Commission is also aware that the courts have expressed a strong disinclination to reopening orders and judgments after a reasonable time. Minnesota courts have held that a state agency has jurisdiction to reopen its orders to correct *erroneous*

adjudications, mistakes of fact or fraud (within or between parties) until jurisdiction is lost by appeal or laspe of time. *State by Turnbladh v. District Court,* 259 Minn. 228, 107 N.W.2d 307 (1960); *Anchor Gas. Co. v. Bongard's Coop. Creamery Ass'n.* 253 Minn. 101,91 N.W.2d 122 (1958). In addition, a one year time limit is placed on the authority of Minnesota courts to reopen their judgments and orders to correct an *erroneous* decision that resulted from mistakes, inadvertance, excusable neglect, newly discovered evidence, or fraud (within and between parties). Minnesota Rules of Civil Procedure, Rule 60.02.

The Commission further recognized that the time limitations imposed on agencies and courts for reopeing their judgments and orders apply to circumstances in which the impetus for reopening is a claim that the judgment or order is *erroneous.* Here the Commission is concerned not with erroneous adjudications but with the integrity of the decision making process itself, and the public's perception of the process.

The real question presented in the matters now under review is whether the ex parte contacts or the conflicts of interest constitute egregious conduct that attacks or undermines an integral aspect of the adjudicatory process or the impartiality of a decison maker. Such conduct is often referred to as "fraud upon the Court" or in this case, "fraud upon the Commission." Courts and administrative agencies have the inherent power with no time limitations to vacate a judgment or decision that has been obtained under such circumstances. *Halloran v. Blue and White Liberty Cab Company,* 253 Minn. 436, 92 N.W.2d 794 (1958); *Universal Oil Products Co. v. Root Refining Co.,* 238 U.S. 575 (1946); *Hazel-Atlas Galss Co. v. Hartford-Empire Co.,* 322 U.S. 238 (1944); *State ex. rel. Corbin v. Arizona Corporation Commission,* 143 Ariz. 219, 693 P.2d 363 (1984); *WKAT, Inc. v. Federal Communications Commission,* 296 F.2d 375 (D.C. Cir. 1961). The Commission concludes that it has the inherent power to remedy matters where it finds that a basic assault and abuse on the regulatory process itself has been committed. Because the Commission has authority to supervise its own processes it can replace the improper process, when it finds such has occurred, with a valid one. Whether such abuse of the process has occurred is a question that must be answered by examining the facts surrounding the ex parte contacts or conflicts of interest.

Some federal courts have attempted to define fraud upon the court as conduct which defies the court itself or in which court officers conduct themselves in a way as to impair judicial machinery and prevent an impartial adjudication. *Serzysko v. Chase Manhattan Bank*, 461 F2d 699 (2d Cir. 1972), *cert. denied* 49 U.S. 883 (1972). Other courts have defined this type of fraud as an unconscionable plan or scheme to improperly influence the court in its decision. *England v. Doyle*, 281 F.2d 304 (9th cir. 1960). The definition that is most often repeated in cases on the issue is that suggested by Professor Moore:

> "Fraud upon the court" should, we believe, embrace only that species of fraud which does or attempts to, subvert the integrity of the court itself, or is a fraud perpetrated by officers of the court so that the judicial machinery cannot perform in the usual manner its impartial task of adjudicating cases that are presented for adjudication... ."
>
> 7 *Moore's Federal Practice*, 60-360.

The Commission agrees that these definitions should be used here to judge whether the cases have been so tainted as to require further action.

The central theme of an inquiry into whether a court's, or an agency's, process has been so abused as to constitute fraud upon the court, or the agency, is to determine if the decision is not a product of fair, unbiased, and impartial judgment, but rather is due to influence caused by improper contacts made to a decision maker. A decision that should be reached impartially but rather is in fact the consequence of improper influences from outside the lawful decision making process should not stand. The object of the Commission's inquiry is to determine whether its decisions were reached by fair and impartial processes or by processes tainted by improper contacts or conflicts of interest.

In order to evaluate whether and to what extent fair processes have been abused in the matters under review, the Commission has considered the following criteria:

1. The gravity of the ex parte communications;

2. Whether the contacts may have influenced the agency's ultimate decision;
3. Whether the party making the improper contacts benefited from the agency's ultimate decision;
4. Whether the contents of the communications were unknown to opposing parties, who therefore had no opportunity to respond; and
5. Whether vacation of the agency's decision would serve a useful purpose.

These criteria were used by the Commission in *Northern States Power Co.*, Docket No. G-002/GR-85-108, Order Vacating December 30, 1985 Order (February 19, 1986), slip op. t 7, citing *Professional Air Traffic Controllers Organization v. Federal Labor Relations Authority*, 685 F2d 547 (D.C. Cir. 1982).

Case law recognized at least three possible administrative responses to improper communications with a decision maker. First, the Commission can decide that no remedial action is required where the ex parte contacts do not significantly taint the decision or cause procedural unfairness. *Professional Air Traffic Controllers Organization v. Federal Labor Relations Authority*, 685 F2d 547 (D.C. Cir. 1982). Second, agency proceedings that have been blemished by ex part communications have been held to be voidable and reconsideration of the decision has been held to be the proper remedy. See, *Massachusetts Bay Telecasters v. FCC*, 295 F.2d 131 (D.C. Cir. 1962). Third, improper ex parte communications may render an agency decision void *ab initio*, and the case must be dismissed or judgment rendered against the violating party. See, *Hazel-Atlas Company v. Hartford Company*, 322 U.S. 238 (1944); *WKAT, Inc. v. FCC*, 296 F.2d 375 (D.C. Cir. 1961).

The Commission will use the five criteria listed above to analyze the matters under review to determine whether and how to exercise its authority to correct abuses to the regulatory process resulting from fraud on the Commission.

II. Should *NWB 83-600* Be Reopened?

Docket No. P-421/GR-83-600

Description of Contacts

The RUD-AG recommended that the Commission reconsider and redeliberate its July 27, 1984 Findings of Fact, Conclusions of Law and Order in *Northwestern Bell Telephone Company*, Docket

No. P-421/GR-83-600. The SRA supported the RUD-AG recommendation. The DPS also recommended redeliberation. MPIRG recommended that the Commission dismiss *NWB 83-600* and reconsider its November 13, 1984 Order Denying Intervenor Compensation.

The MBUUC states that reconsideration or dismissal of *NWB 83-600* may not serve the public interest, causing more disruption and harm than benefit. NWB recommended that the Commission dismiss the RUD-AG petition for reconsideration and the MIRG [sic] petition to dismiss *NWB 83-600*.

Based on the record, including the DPS report and exhibits and the pleadings of the parties, the Commission makes the following findings of fact:

In August, 1983 NWB announced its intention to file a rate increase with the Commission. It did so on September 29, 1983 requesting a $109 million increase in rates. The Commission issued its Findings of Fact, Conclusions of Law and Order on July 27, 1984. The case concluded on October 25, 1984 when the Commission denied requests for intervenor compsenation. The Commission authorized a rate increase of $57,148,000 for NWB.

During the pendency of this rate case, a NWB Assistant Vice President, Roy Weir, took sitting Commissioners out for numerous meals. He dined most frequently with then-Commissioners Leo G. Adams and Roger L. Hanson. Records provided to the DPS and incorporated in its July 8, 1986 Report show that between September 2, 1983 and October 26, 1984, NWB provided more than 100 meals in total to then-sitting Commissioners and their spouses. The frequency of these free meals increased when important issues in *NWB 83-600* were raised. In a deposition taked by the DPS for the Report, Mr. Weir also stated that he provided baseball tickets, flowers, and other gifts to Commissioners, but did not give details. Weir Deposition 84-124; DPS Report 29. Mr. Weir's expenses for these meals and gifts had the explicit approval of his former superior, then Chief Executive Officer and Vice President, Thomas Madison. Madison Deposition, 29-40; DPS Report 30.

On April 26, 1984, NWB announced a corporate restructuring to become effecitve April 30, 1984. On May 2, 1984 Mr. Weir entertained Commissioner Adams and his wife. On May 4, 1984, the Commission ordered the DPS to investigate Bell's restructuring.

Mr. Weir entertained Commissioner Adams on May 7, 1984; Commissioner Hanson on May 9, 1984; Commissioner Hanson on May 14, 1984; Commissioner Adams on May 15, 1984. On May 16, 1984 motions to dismiss *NWB 83-600* were filed by Evan J. Henry, MPIRG, Recipient Families United for Justice and the Minnesota Senior Federation, the St. Cloud Area Ratepayers, and the DPS. On May 17, 1984 the DPS entered into a stipulation with NWB and formally withdrew its motion to dismiss. Mr. Weir hosted a meal for Commissioner Hanson on May 17, 1984; Commissioner Adams on May 18, 1984; Commissioner Adams and his wife on May 19, 1984.

On May 22, 1984, the Administrative Law Judge (ALJ), Bruce D. Campbell recommended dismissal of *NWB 83-600* to the Commission. On May 23, 1984, the Commission met to discuss the ALJ's recommendation and established a schedule for oral argument on reconsideration. That evening Mr. Weir took Commissioner Hanson and his wife to dinner. Mr. Weir hosted Commissioner Adams on May 25, 1984; Commissioner Adams and wife on May 30, 1984; Commissioner Adams on May 31, 1984; and Commissioner Adams and his wife on June 2, 1984.

Oral Arugment on the motions to dismiss *NWB 83-600* was held on June 5, 1984. On June 6, 1984, Mr. Weir hosted a meal for Commissioners Adams and Hanson. The following day, June 7, 1984, Commissioner Hanson wrote a memorandum to the other Commissioners recommending denial of the motions to dismiss *NWB 83-600*. The following day, June 8, the commission sent a letter to the ALJ stating its belief that due process would best be served by addressing the NWB corporate restructuring issue within the context of *NWB 83-600*. The letter stated that the Commission intended, upon rendering a decision on the record of the rate case, to move on its own motion for rehearing on all the additional issues occasioned by the restructuring. The Commission asked the ALJ to issue his Report in the rate case based on the then-existing record. On June 8, Mr. Weir and Commissioners Adams and Hanson again dined at NWB's expense. Five days later, on June 13, 1984, Mr. Weir entertained Commissioners Adams and Hanson and their wives at a private club in Lakeville, Minn. On June 19, 1984, Mr. Weir and Commissioner Adams dined together in Chicago.

On June 19, 1984, the ALJ issued Part I of his Report. The ALJ issued Part II of his Report on June 26, 1984. On that date, Mr. Weir hosted a meal for Commissioner Adams and his wife. On the following day, Mr. Weir dined with Commissioner Hanson. On July 3, 1984, Mr. Weir entertained Commissioner Adams. Two days later, July 5, the Commission was briefed by its staff on the issues in *NWB 83-600*. On July 6, 1984 while the staff briefing continued, Mr. Weir took Commisioner Adams out for one meal and Commissioner Hanson out for another. The Commission heard oral argument in *NWB 83-600* on July 9, 1984 and deliberated the case July 10 through July 13. On July 11, Mr. Weir and Commissioners Hanson and Adams and spouses went out for a meal at NWB's expense. Mr. Weir hosted Commissioner Adams on July 16; Commissioner Adams and his wife on July 18; Commissioners Hanson and Adams on July 19; Commissioner Hanson on July 23; and Commissioner Adams on July 25.

The Commission issued it Findings of Fact, Conclusions of Law, and Order in *NWB 83-600* on July 27, 1984. Mr. Weir entertained Commissioner Hanson on July 30; Commissioner Adams on July 31; Commissioner Hanson on August 3; and Commissioner Adams and his wife on August 4.

On August 6, 1984 NWB filed a petition for reconsideration of the Commission's July 27, 1984 Order. Mr. Weir hosted Commissioner Adams on August 7; Commissioner Adams and his wife on August 9; one meal for Commissioner Hanson and another meal for Commissioners Hanson, Adams and their wives on August 16; Commissioners Hanson and Adams on August 21.

The Commission met on August 23, 1984 and decided to rehear the issue of the financial impact of NWB's corporate reorganization. On August 25, 1984 Mr. Weir hosted Commissioner Adams and his wife. On August 27, 1984 the Commission issued its Notice Order and for Rehearing. On that date, Mr. Weir bought Commissioner Adams one meal and Commissioner Hanson and his wife another. On September 5, Mr. Weir hosted Commissioner Adams and his wife at two meals. On September 7, Mr. Weir entertained both Commissioners Adams and Hanson. Mr. Weir also hosted Commissioner Adams on September 11. The Commission reconsidered *NWB 83-600* on September 12 and 13, 1984. On September 13, Mr. Weir entertained Commissioner Hanson with one meal and

Commissioner Adams and his wife with another. Mr. Weir hosted Commissioner Hanson on September 14 and Commissioner Adams on September 19. He bought Commissioner Hanson a meal on September 21, and both Commissioners Hanson and Adams meals on September 25. On that date the Commission issued its Order After Rehearing in *NWB 83-600* which dealt with NWB's corporate restructuring.

The last petition for intervenor compsensation was filed on September 28. On that date Mr. Weir hosted Commissioners Hanson and Adams. On October 2, he entertained Commissioner Adams. On October 4 Mr. Weir provided Commissioner Adams and his wife one meal and Commissioner Hanson another. He hosted both Commissioners Hanson and Adams on October 12; Commissioner Hanson on October 19; and Commissioner Hanson again on October 25. On that date the Commission denied the requests for intervenor compensation. The next day, October 26, Mr. Weir took Commissioner Hanson to lunch and Comissioner Adams and his wife to dinner.

In summary, NWB provided more than 100 meals to sitting Commissioners and their spouses in the 14 month period between September 2, 1983 and October 26, 1984; Commissioner Adams received approximately 50 meals, Commissioner Hanson, 34 meals, and their wives, 25 meals. The DPS Report stated that in the 19 month period in 1982-1984 for which records were requested Commissioner Adams received approximately $2700 in meals from NWB and Commissioner Hanson received approximately $870 in meals from NWB.

Mr. Weir's supervisor, Thomas Madison, described Mr. Weir's actions as "developing a communications path." Madison Deposition 40, DPS-30. According to Mr. Weir's records, the meals were "quiet business meals." However, Mr. Weir denied that business was the main purpose of the meals. Weir Deposition-11, DPS-29, Weir Deposition 85, DPS 33. Mr. Weir's job as a lobbyist "was selling a product, selling a service, selling a company." Weir Depostition-55, DPS-30. Mr. Weir testified that he wanted to use the contacts to establish a relationship with the Commissioners "so that whatever problems they saw in our company or proposal they wanted to make about what we should be doing or how we operate ... whatever they'd have that they would want to share that they'd feel

comfortable saying, Roy, we don't think you're doing a good job, and they did that." Weir Deposition-55, 56, DPS-30, 31. Mr. Weir states that it was his policy to brief Commissioners on NWB's actions and issues just before they were filed with the Commission, but he would not discuss general rate case matters. Weir Deposition-50, DPS-66. Commissioners Hanson and Adams confirmed Mr. Weir's practice, stating that they were aware of the need to avoid discussions of contested matters when a formal contested case was pending. Hanson Deposition-21, Adams Deposition-19, DPS-66. Mr. Weir and former Commissioners Adams and Hanson stated that they never discussed the merits of contested cases at these meetings (meals) and denied the improper ex parte contacts occurred. DPS-64.

Commissioner Hanson did not dispute the accuracy of Mr. Weir's expense reports and acknowledged that Mr. Weir paid for the meals. He said that there were reasons for the frequent contact, including that Mr. Weir was a good friend. Commissioner Hanson stated the he valued Mr. Weir's advice. Hanson Deposition-45, DPS-35. Commissioner Hanson testified that he did not believe Mr. Weir attempted to influence his vote. Hanson Deposition-84, DPS-35.

Commissioner Adams states that he did not consider the frequent meals as improper nor did he consider that it might appear improper. Adams Deposition-93. He allowed Mr. Weir to pay for all the meals because Mr. Weir had invited him. Adams Deposition 39, 40, DPS-33. Finally Commissioner Adams stated that he did not discuss issues in pending cases with Mr. Weir, nor did he feel that his votes were influenced by his close association and regular contacts with him. Adams Deposition-93, DPS-34.

Gravity of NWB Contacts With Commissioners

In assessing the gravity and propriety of NWB's contacts with former Commissioners Adams and Hanson, the Commission must recognize the frequency and timing of the meals privided by NWB. While the participants to these meetings have testified that they did not discuss NWB's position in *NWB 83-600*, the Commission must recognize the necessary and logical effects of these meetings. A person is considered to intend the logical consequences of his or her actions. Intent can be determined by drawing obvious inferences from objective fact. Here, the facts speak for themselves.

Mr. Weir, a NWB Assistant Vice President, provided more than

100 meals in total to sitting Commissioners and their spouses between September 2, 1983 and October 23, 1984 in addition to providing various gifts. Mr. Weir's expenses for these meals and gifts had the explicit approval of his former superior, then Chief Executive Officer and Vice President, Thomas Madison. As discussed above many of these meals coincided with Commission discussions and deliberations on issues critical to NWB's general rate case. The entertainment and contacts were much less frequent during less critical stages of the Commission's decision process. The obvious inference from these facts is that NWB intended to influence decision makers through its generosity and almost limitless hospitality.

The Commission finds that the sheer number of free meals adds to the gravity of these ex parte communications. Further, in analyzing their timing, the Commission recognizes, as it must, that the seriousness of these ex parte contacts is compounded by the pattern of extended hospitality at times critical to NWB's rate case. The Commission concludes that the ex parte contacts summarized above are a serious abuse and violation of the regulatory process.

The Influence of the Contacts on the Agency's Utlimate Decision

The Commission finds that it is difficult to accurately assess the effect NWB's action had on particular votes on particular issues. However, the Commission has found that NWB's method of selling the Company and opening a "communications path" to the Commission through free meals and other gifts was designed to promote a favorable regulatory environment for NWB. The Commission concludes tht the relationship between Mr. Weir and Commissioners Adams and Hanson creates, at a minimum, the impression of an atmospheré unduly receptive to Bell positions and beneficial to the Company.

Benefit to NWB

The Commission is aware that Mr. Weir and former Commissioners Adams and Hanson have testified that issues pending before the Commission were never discussed at any of the meals they shared. While the timing of the contacts increased at crucial times in the rate case, the Commission has no concrete evidence of the substance of the discussions at those meetings. However, the Commission finds that it is logical to assume that NWB expected to receive a corporate benefit from the time and money it spent in entertaining sitting Commissioners.

NWB is a heavily regulated utility and must be charged with the knowledge of the regulatory scheme envisioned by the Legislature and codified in the Administrative Procedure Act (Minn. Stat. Ch. 14). When the regulatory atmosphere even slightly favors one party, the due process rights of other parties are violated. Here NWB made a concerted effort to court two Commissioners who were responsible with ensuring that NWB's rates are fair and reasonable. Minn. Stat. § 237.06 (1986). NWB's actions cannot be realistically viewed as separate from *NWB 83-600.* Those actions were directed to create a favorable milieu of the corporate image of NWB, making the general atmosphere for regulating NWB more friendly and more open to the NWB proposals than the regulatory process alone would allow. The Commission finds that it is only logical to assume that NWB expected that the time and money it spent on these entertainments would be reflected in favorable Commission decisions. Clearly Mr. Weir viewed himself as a lobbyist. The Commission cannot believe that his actions and hospitality were not directed at favorably influencing former Commissioners Adams and Hanson to NWB's views in its rate case. This type of favored status is particularly insidious because it is not readily apparent to other participants in the rate case. The Commission concludes that these contacts were intended to benefit NWB in *NWB 83-600.*

Integrity and Fairness of Process

The Commission will next address whether NWB's ex parte contacts threatened the integrity and fairness of the rate case process and denied opposing parties an opportunity for effective response.

Although these contacts occurred in restaurants these communications were private. Other participants in the ratemaking process were not given advance notice of the meetings, did not participate, and were not able to respond to any of the discussions effectively. The nature of these meetings and NWB's purpose in promoting them cast a cloud over the regulatory process and denied other parties and the public any effective opportunity to respond in *NWB 83-600.* The Commission finds that the Company's intent to influence decision makers outside of the regulatory process as evidenced by its actions violated the rights of the other parties. The Commission concludes that the fairness and integrity of the regulatory process have been seriously impaired and frustrated by the action of NWB discussed above.

Future Commission Action

The Commission finds that the actions of NWB and former Commissioners Hanson and Adams demand corrective measures. The ex parte communications described above are a serious infringement and abuse of the regulatory process. They were designed to influence decisionmakers without allowing other parties to respond to them, thereby denying due process to the other parties in the rate case and to NWB's ratepayers. Further, the actions have tainted the decisions in *NWB 83-600*, have created an atmosphere of public distrust and lack of confidence in the regulatory process and must be corrected.

The Commission must determine a remedy that is commensurate with the degree of harm NWB has inflicted on the regulatory process. The range of corrective actions can be viewed as points along a continuum, with no remedy being required at one end, where there had been no harm, and dismissal of a proceeding at the other, where there has been great and irrevocable harm.

The Commission has considered the alternative of dismissing *NWB 83-600*. This response would be appropriate where either the gravity or the consequences of the communications were more than found here. The Commission has recently dismissed a case where a utility applicant discussed employment with a former Commissioner who was about to decide its pending rate case, and the former Commissioner repeatedly supported the utility's position in the decision-making process. *Northern States Power Company* Docket Nos. G-002/GR-85-108, G-0002/GR-85-282 Order Vacating December 30, 1985 Order, Dismissing General Rate Case, Discontinuing Interim Rates and Requiring Refund of Interim Rates (February 19, 1986). The Commission found that dismissing the NSP case was the only action that would effectively remedy the abuse of the decision-making process that resulted from ex parte contacts and conflicts of interest that had so prejudiced the proceeding that the Commission could not consider it impartially. See, *WKAT, Inc. v. FCC*,296 F. 2d 375 (D.C. Cir. 1961).

A cruicial difference between this case and the NSP case is that the Commission does not know the content of discussions at the meetings between Mr. Weir and Commissioners Adams and Hanson. While the evidence shows a general intent and effort to influence, the Commission cannot find here either the benefit offered or

the direct effect on deliberations present in the NSP case. The cause and effect relationship between these contacts in *NWB 83-600* is not as clear as in *NSP* G-002/GR-85-108, G-002/GR-85-282.

The remedy of dismissal must serve a useful purpose. When the administrative result and ensuing confusion of dismissing three years of rates already collected is considered, the consequential loss of three years of increased rates to NWB would be much harsher than the consequential loss of one year of rates to NSP. Here, neither the gravity of the offense nor the weight of the evidence make the contacts between NWB and the Commissioners Hanson and Adams as egregious as the employment offer made by NSP to Commissioner Adams. Thus, the NWB case does not merit the same result as NSP, let alone a harsher result. Therefore, the Commission does not find that the extreme remedy of dismissal is appropriate in this case. The Commission will deny MPIRG's petition to vacate and dismiss *NWB 83-600*.

An alternative at the other end of the continuum, that of ordering no remedial action because no harm resulted from the ex parte communications, is unreasonable in this case. As discussed above, the ex parte contacts between NWB and sitting Commissioners were serious both in light of their number and their timing. The Commission has found that they caused procedural unfairness in *NWB 83-600*. A remedy is clearly called for.

The Commission finds that redeliberating this case is necessary to remove the taint of the ex parte contacts between NWB and Commissioners Adams and Hanson. Redeliberation by the present Commission can remove any partiality or appearance of partiality from the original decisions in *NWB 83-600* and restore public confidence and trust in regulation. Since the decision in *NWB 83-600*, Commissioners Hanson and Adams have left the Commission, and therefore, any bias they may have brought to the decisionmaking process has been removed. Therefore, the Commission will vacate its July 27, 1984 decision in this matter and concludes that *NWB 83-600* should be redeliberated. The Commission will conduct the redeliberation and issue a separate Order after redeliberation in Docket No. P-421/GR-83-600.

The Commission also finds that NWB must take remedial action to see that the serious abuses of the regulatory process that occurred in the past do not happen again. The affidavits of NWB personnel

indicate that they felt the frequent entertaining of sitting Commissioners discussed above was acceptable behavior; NWB corporate policy supported such behavior by reimbursing employees for these entertainment expenses. The Commission, however, does not find such practices by a regulated utility to be acceptable, for the reasons given above and as expressed in its orders adopting rules governing a code of conduct for the Commission and its staff and governing ex parte contacts.

To help avoid such abuses by NWB in the future, the Commission will direct NWB to file with the Commission: 1) a written code of conduct for its employees to follow in dealing with the Commission and its staff and 2) written procedures for review of employee expense records and reimbursement requests for regulatory activities. For a company as large as NWB, internally publicized, written rules will assist employees to conduct themselves properly. NWB is to ensure that its policies conform to the Commission's Code of Conduct and Ex Parte rules, Minnesota Rule, parts 7845.0100 to 7845.100 and parts 7845.7000 to 7845.7600 respectively.

The Commission will also deny MPIRG's request to reconsider the November 13, 1984 Order Denying Intervenor Compensation, in which MPIRG was denied intervenor compensation. That Order was appealed to the Minnesota Court of Appeals and the Minnesota Supreme Court; the Commission's decision with respect to MPIRG was affirmed. *In the Matter of the Application of Northwestern Bell Telephone Company,* 386 N.W.2d 723 (Minn. 1986). Since the Court has affirmed the criteria and standards used by the Commission to evaluate MPIRG's petition for intervenor compensation, the Commission will not reconsider the request at this time. This decision does not preclude MPIRG from submitting a new request for intervenor compensation after the Commission has issued its order after redeliberation in *NWB 83-600*, if MPIRG believes it would then qualify under the Commission's previously adopted criteria.

***

ORDER

1. The Commission Order of July 27, 1984 in *NWB* Docket No. P-421/GR-83-600 is vacated and the case is reopened for further deliberation and the issuance of a new decision and order.
2. The Commission Orders in *Interstate Intercity telecommunications Services,* Docket No. P-442 et al/NA-84-212; *United Telephone Company,* Docket No. P-430/GR-84-597; *New Ulm Telecom,* Docket No. P-419/NA-84-334; *NWB,* Docket No. P-421/CI-83-144 and P-421/M-83-167; and *NWB.* Docket No. P-421/CI-82-619, P-421/M-82-512, and P-421/M-83-127 shall not be reopened.
3. The August 14, 1986 Petition of the Minnesota Public Interest Research Group for vacation and dismissal of the Commission's July 27, 1984 and November 13, 1984 Orders in *NWB 83-600* is denied.
4. The July 9, 1986 Petition of the Residential Utilities Division of the Attorney General's Office to reopen and redeliberate its July 27, 1984 Order in *NWB 83-600* is granted.
5. Within 30 days of the service date of this Order, Northwestern Bell shall file with the Commission a written code of conduct and written expense reimbursement policies as described herein.
6. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION
Marry Ellen Hennen
Executive Secretary

APPENDIX 9

BEFORE THE
MINNESOTA PUBLIC UTILITIES COMMISSION

Barbara Beerhalter	Chair
Harry Seymour Crump	Commissioner
Cynthia A. Kitlinksi	Commissioner
Robert J. O'Keefe	Commissioner
Darrel L. Peterson	Commissioner

ISSUE DATE: April 03, 1987

In the Matter of the Application of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota

Docket No. P-421/GR-83-600

ORDER AFTER REDELIBERATION

Procedural History

On September 29, 1983, Northwestern Bell Telephone Company (Northwestern Bell, NWB or the Company) filed a petition for increased rates with the Minnesota Public Utilities Commission (the Commission), pursuant to Minn. Stat. § 237.075 (Supp. 1983). NWB's originally proposed change in rates would have increase its intrastate annual gross revenues by $109,461,000. In testimony filed February 8, 1984, the Company proposed revenue increase was revised downward to $98,174,000. In its Initial Brief, filed on April 20, 1984, the Company's requested increase in annual revenue was stated to be $107,587,000.

The Commission accepted NWB's filing and suspended the proposed rates by Order dated October 21, 1983. On that same date, the Commission issued its Notice and Order for Hearing directing

that a hearing be conducted on the Company's petition. Administrative Law Judge Bruce D. Campbell (ALJ) was assinged to the proceeding by the Office of Administrative Hearings.

Pursuant to Minn. Stat. § 237.075, subd. 3 (Supp. 1983), the Commission, by Order dated November 22, 1983, authorized and set the Company's interim rates at a level sufficient to collect $53,778,000 in additional revenues, subject to refund, pending a final Order by the Commission. The interim rates became effective for service rendered on and after November 28, 1983.

A prehearing conference was held by the ALJ on November 18, 1983. A Prehearing Order establishing the hearing schedule and procedural guidelines was issued on December 13, 1983. Pursuant to Minnesota Rules, part 1400.6200, Petitions for Intervention were filed and the following were made parties to the proceeding: the Minnesota Department of Public Service (DPS or the Department); the Residential Utilities Division of the Office of the Attorney General (RUD-AG); the Minnesota Department of Administration (DOA); Evan J. Henry, ratepayer; the Minnesota Public Interest Research Group (MPIRG); the Surburban Rate Authority (SRA); North Star Legal Foundation (NSLF); Recipient Families United for Justice (RFUJ); Minnesota Senior Federation (MSF); AT&T Communications of the Midwest, Inc. (AT&T/MW): The Minnesota Business Utility Users Council (MBUUC); The County of Ramsey; the United States Department of Defense on Behalf of the Interest of all Federal Executive Agencies (FEA); Polly Vesser, Renay Post, Sophie Jendro and Cindy Graham, ratepayers (St. Cloud Area Ratepayers or SCAR); the Coalition of FX Users (FX Users); Telecommunications Association of Minnesota (TAM); the Minnesota Radio Common Carriers Association (MRCCA): and NewVector Communications, Inc. (NewVector). The Petitions for Intervention of MRCCA and NewVector were granted by Commission Orders of February 21, 1984 and march 21, 1984 respectively.

The ALJ conducted evidentiary hearings in St. Paul on January 9, 10-13, 16-20, 23-27 and 30, 1984; March 12-16, 19-23, 26 and 27, 1984; and April 5, 1984.

Appearances at the evidentiary hearings were as follows: James A. Gallagher and Gregory A. Ludvigsen, Attorneys, 200 South Fifth Street, Room 1800, Minneapolis, Minnesota 55402 and Richard A. Karre, Attorney, 1314 Douglas, Omaha, Nebraska

68102, represented Northwestern Bell Telephone Company; Kenneth A. Nickolai, Susan W. Rester, James T. Jarvis, and Christopher K. Sandberg, Special Assistant Attorneys General, 1100 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, represented the Department of Public Service; Michael J. Bradley, Assistant Attorney General and Thomas M. O'Hern, Jr., and Dennis D. Ahlers, Special Assistant Attorneys General, Residential Utilities Division, Office of the Attorney General, 340 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, represented the Attorney General Hubert H. Humphrey III; W. Richard Morris, Attorney, 10825 Old Mill Road, Omaha, Nebraska 68154 and Samuel L. Hanson, Attorney, Briggs and Morgan, 2400 IDS Center, Minneapolis, Minnesota 55402 respresented AT&T Communication of the Midwest; Carla Kjellberg, and Gail Suchman, Attorneys, 2412 University Avenue Southeast, Minneapolis, Minnesota 55414, represented the Minnesota Public Interest Research Group; Kathleen M. Davis, Attorney, Minneapolis Legal Aid Society, 323 Fourth Avenue South, Minneapolis, Minnesota 55415, represented the Minnesota Senior Federation; Eliot Rothenberg, Attorney, 850 Builders Exchange Building, Minneapolis, Minnesota 55402, represented North Star Legal Foundation; Larry D. Starns, Special Assistant Attorney General, 204 Administration Buiding, 50 Sherburne Avenue, St. Paul, Minnesota 55155, represented the Minnesota Department of Administration; Lawrence R. McDonough, Attorney, St. Cloud Area Legal Services, 125½ East Broadway, Little Falls, Minnesota 56345, represented Polly Vesser, Renay Post, Sophie Jendro and Cindy Graham, ratepayers; Eldon J. Spencer, Jr., Attorney, 800 Northwestern Center, St. Paul, Minnesota 55101 represented the Coaltition of FX Users; Glen E. Purdue and James M. Strommen, Attorneys , 2000 First Bank Place West, Minneapolis, Minnesota 55402, represented the Suburban Rate Authority; Carol Casebolt, Attorney, Legal Aid Scoiety of Minneapolis, 222 Grain Exchange Building, Minneapolis, Minnesota 55415, represented Recipient Families United for Justice; William E. Flynn, Attorney, 3800 IDS Tower, 80 South Eighth Street, Minneapois, Minnesota 55402, represented the Minnesota Business Utility Users Council; Elissa Mautner, Assistant Ramsey County Attorney, 200 Lowry Square, St. Paul, Minnesota 55102, represented the County of Ramsey;

Russell L. Doty, Attonery, Suite 814, Degree of Honor Buiding, 325 Cedar Street, St. Paul, Minnesota 55101, represented the Minnesota Radio Common Carriers Association; Dwight M. Whitley, Attorney, 3350 161st Avenue Southeast, Bellevue, Washington 98008 and John B. Van de North, Attorney, Briggs and Morgan, 2400 IDS Center, Minneapolis, Minnesota 55402, represented NewVector communications, Inc.; Evan J. Henry, Route 1, Box 60, Winona, Minnesota 55987, appeared *pro se*; and Karl W. Sonneman, Special Assistant Attorney General, and Mark E. Oberlander, Karin F. Leonard, and Everett J. Kulas, 780 American Center Building, 160 East Kellogg Boulevard, St. Paul, Minnesota 55101, represented the Minnesota Public Utilities Commission.

Public hearings to receive customer comments and questions regarding the proposed increase were held on the following dates and in the following locations. Parenthetical numbers indicate the number of persons attending each hearing. Bracketed numbers indicate the number of persons speaking at each hearing.

January 23, 1984	St. Paul	(150)	[12]	1:00 p.m.
January 23, 1984	St. Paul	(15)	[13]	7:00 p.m.
January 24, 1984	Winona	(35)	[18]	
January 25, 1984	Owatonna	(27)	[8]	
January 26, 1984	Marshall	(30)	[11]	
January 27, 1984	Willmar	(2)	[2]	
February 7, 1984	Duluth	(40)	[6]	
February 8, 1984	Virginia	(30)	[6]	
February 9, 1984	Crookston	(4)	[3]	
February 10, 1984	Moorhead	(3)	[1]	
February 21, 1984	Faribault	(140)	[12]	
February 22, 1984	Minneapolis	(500)	[12]	1:00 p.m.
February 22, 1984	Minneapolis	(30)	[12]	7:30 p.m.
February 23, 1984	Cambridge	(100)	[16]	
February 24, 1984	Little Falls	(85)	[14]	

Nineteen public exhibits were received into the record. Several additional public exhibits were offered but later excluded from evidence by the ALJ.

Due to time constraints, the ALJ declined to hold a public hearing in Duluth during the afternoon of February 7, 1984. An

"unofficial hearing" or public gathering was held without the presence of the ALJ. It is asserted that 134 people attended that gathering and an unoffical tape record of the proceeding and an attendance roster were introduced into the record at the evening public hearing as Public Exhibit 2. The ALJ estimated that more than 80% of the persons attending the public hearings were senior citizens. In addition to the testimony received at the public hearings, the ALJ received more than 300 letters, all of which were reviewed and included in the record of this proceeding. In the summary of public testimony that is contained in Part III of this Order, no distinction has been made between public oral testimony and public letters.

On April 26, 1984, Northwestern Bell presented to the Commission a proposed corporate restructuring. As part of this presentation, NWB provided documents which it had filed before the Federal Communications Commission (the FCC) which were designed to comply with an FCC order (CC Docket No. 83-115, released on December 20, 1983). The FCC, in that order, imposed the structural separation requirements of 47 C. F. R. § 64.704 on the divested Bell Opeating Companies (BOCs) in their offering of customer premises equipment (CPE) and enhanced services if they intended to provide such services after the divestiture. NWB is one of the 22 divested BOCs.

In its presentation before the Commission, NWB informed the Commission that to comply with the FCC's December 30, 1983 Order it would incorporate a new holding company, Northwestern Bell Corporation, on April 30, 1984. Northwestern Bell Corporation would have as its subsidiaries Northwestern Bell Telephone Company (NWBT), and Northwestern Bell Information Technologies, Incorporated. NWBT would encompass all present operations of NWB and would be regulated by the Commission. Northwestern Bell Information Technologies, Incorporated would be a new company formed on May 3, 1984, and would not be regulated by the Commission.

On May, 4, 1984, the Commission issued an Order directing the DPS to investigate the corporate reorganization of NWB and affiliated corporations and to respond to specific Commission inquiries *In the matter of an Investigation by the Minnesota Public Utilities Commission into the Corporate Restructuring of North-*

western Bell Telephone Company, Docket No. P-421/C1-84-192.

By letters dated May 8 and 9, 1984, the ALJ, on his own motion, convened a Post-hearing Conference and described to the parties the evidentiary status to be afforded the discussions occurring at that conference. The ALJ stated in a May 9, 1984 letter that his sole purpose in conducting the Post-hearing Conference was to attempt to reach some conclusion about the extent to which the record in this proceeding would reflect the business activities of the divested, reorganized company during the period within which any revised rate may be in effect. He emphasized that the purpose of the Post-hearing Conference was to extend the hearing to accommodate additional substantive evidence regarding the reorganization of NWB. At the Post-hearing Conference. all counsel present were afforded an opportunity to make oral argument with respect to the matters discussed at the Conference.

Appearances at the Post-hearing Conference were as follows: Melvin R. Quinlan, Attorney, 1314 Douglas on the Mall, Omaha, Nebraska 68102 and James A. Gallagher, Attorney, 200 South Fifth Street, Room 1800, Minneapolis, Minnesota 55402, appeared on behalf of NWB; Kenneth A. Nickolai and Susan W. Rester, Special Assistant Attorneys General, 1100 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, appeared on behalf of the DPS; Thomas M. O'Hern, Jr., and Dennis Ahlers, Special Assistant Attorneys General and Michael J. Bradley, Assistant Attorney General, 340 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, appeared on behalf of the RUD-AG; James M. Strommen, Attorney, 2000 First Bank Place West, Minneapolis, Minnesota 55402, appeared on behalf of the SRA; Samuel L. Hanson, Attorney, 2400 IDS Center, Minneapolis, Minnesota 55402, appeared on behalf of AT&T/MW; Carla Kjellberg, Attorney, 2412 University Avenue S.E., Minneapolis, Minnesota 55414, appeared on behalf of MPIRG: Kathleen M. Davis, Attorney, Minneapolis Legal Aid Society, 323 South Fourth Avenue, Minneapolis, Minnesota 55415, appeared on behalf of the MSF; Larry D. Starns, Special Assistant Attorney General, 204 Administration Building, 50 Sherburne Avenue, St. Paul, Minnesota 55155, appeared on behalf of the DOA; William E. Flynn, Attorney, 3800 IDS Tower, 80 South Eighth Street, Minneapolis, Minnesota 55402, appeared on behalf of MBUUC; Carol Casebolt,

Attorney, Minneapolis Legal Aid Society, 222 Grain Exchange Building, Minneapolis, Minnesota 55415, appeared on behalf of RFUJ; Lawrence R. McDonough, Attorney, St. Cloud Area Legal Services, 125-½ East Broadway, Little Falls, Minnesota 56345, appeared on behalf of the St. Cloud Area Ratepayers; John B. Van de North, Briggs and Morgan, Attorneys at Law, 2400 IDS Center, Minneapolis, Minnesota 55402, appeared on behalf of NewVector; and Mark E. Oberlander, 780 American Center Building, 160 East Kellogg Boulevard, St. Paul, Minnesota 55101, appeared on behalf of the Commission. In addition, each Commissioner of the Public Utilities Commission was present for all or a significant portion of the Post-hearing Conference.

Pursuant to written Motions, dated May 16, 1984, the following parties to the above captioned proceedings timely requested that the ALJ recommend to the Minnesota Public Utilities Commission a summary disposition or dismissal of the pending general rate increase requested by Northwestern Bell Telephone Company: The DPS; the RFUJ; the St. Cloud Area Ratepayers, Evan J. Henry; the MPIRG: and the MSF. Such Motions were accompanied by supporting memoranda of law. On May 17, 1984, the DPS entered into a Stipulation with Northwestern Bell (Stipulation), and formally withdrew its previous Motion to Dismiss. On May 18, 1984, Northwestern Bell timely filed a memorandum of law opposing the Motions to Dismiss.

The ALJ submitted the Recommendation of Administrative Law Judge Regarding Motions for Summary Disposition or Dismissal to the Commission on May 22, 1984.[1] The ALJ recommended that the application of NWB for authority to change its schedule of telephone rates for Minnesota customers be dismissed for failure of the Company to sustain its statutory burden of proof. Minn. Stat. § 237.075, subd. 4 (Supp. 1983).

On May 23, 1984, the Commission met to consider the ALJ's Recommendation of Dismissal. The Commission viewed the Recommendation as a possible final disposition of a contested case proceeding. Minn. Stat. § 14.61 (1982) provides that in a contested case a final decision cannot be made until the report of the ALJ

[1]The Commission has excerpted portions of that Recommendation herein without specific attribution.

has been made available to parties for at least 10 days and affords an opportunitty for adversely affected parties to file exceptions and present oral argument. Consequently, Oral Argument on the ALJ's Recommendation for Dismissal was held on June 5, 1984. The following parties participated in the Oral Argument: MPIRG, MSF, RFUJ, St. Cloud Legal Service, NWB, DPS, MBUUC, and the RUD-AG.

On June 8, 1984, the Commission sent a letter to the ALJ stating its belief that due process would best be served by addressing the restructuring issue within the context of this proceeding. The letter stated that the Commission intended, upon rendering a decision on the record of this proceedig to move on its own motion for rehearing on all the additional issues occasioned by the restructuring. The Commission requested that the ALJ issue his Report on the basis of the existing record.

Post hearing briefs were received by the ALJ by May 30, 1984 at which time the record closed.

The ALJ submitted Part I of his Report to the Commission on June 19, 1984. He submitted Part II on June 26, 1984.[2]

The Commission heard Oral Argument on July 9, 1984.

The Commission issued its Findings of Fact, Conclusions of Law and Order in this proceeding on July 27, 1984 (July 27, 1984 Order) authorizing a rate increase of $57,511,000 exclusive of the test year effects of the corporate restructuring that occurred on or about April 30, 1984.

Petition for Reconsideration or Rehearing of the July 27, 1984 Order were filed by the RUD-AG and NWB on August 6, 1984; by the MRCCA, NewVector, the DPS and Evan J. Henry on August 16, 1984.

The Company filed Replies to the Petition of the RUD-AG on August 16, 1984 and to the Petitions of the DPS, the MRCCA, NewVector, and Evan J. Henry on August 28, 1984. The RUD-AG and the DPS filed Responses to the Company's Petition for Reconsideration on August 17, 1984. On that date, the MBUUC filed its Response to the RUD-AG's Petition for Reconsideration.

The July 27, 1984 Order directed to DPS to submit to the Commission and serve all parties to this proceeding a report of its

[2]The Commission has excerpted portions of these Reports herein without specific attribution.

investigation regarding the corporate reorganization of NWB undertaken in *NWB*, P-421/CI-84-192. Any party wishing to submit comments regarding the DPS report was directed to do so in writing to the Commission and serve them on all parties no later than August 14, 1984.

On August 1, 1984, the DPS submitted its Report in *NWB*, P-421/CI-84-192 to the Commission. The report was also served on all parties. In the August 1, 1984 Report, the DPS indicated its preliminary findings that the $57,511,000 rate increase authorized in the July 27, 1984 Order should be reduced by $371,000 to reflect the financial impact of the Company's reorganization pertaining to the test year used in this proceeding. The DPS indicated that the $371,000 reduction was a preliminary adjustment which it would subsequently revise to conform with the Commission's findings in the July 27, 1984 Order. Comments were filed by the RUD-AG and NWB on August 14, 1984. The FEA submitted comments on October 1, 1984. No party contested the DPS Report with regard to the impact of the restructuring upon the test year revenue deficiency. Mr. Henry did not submit comments.

On August 3, 1984, Northwestern Bell filed with the Commission proposed tariff pages containing revised rates that would generate $57,511,000 of additional revenues and a proposed customer notice in compliance with the July 27, 1984 Order. Northwestern Bell also sent a copy of its compliance tariffs and notice to all parties.

On August 24, 1984, the DPS served a memorandum on all parties which calculated the amended effect of the corporate restructuring as a downward adjustment of $363,000 to the rate increase authorized by the Commission in its July 27, 1984 Order. The amended calculation reflected the cash working capital impact of the adjustments to the test year income statement and the lower rate increase. The revised adjustment also reflected an amendment to the pro forma interest expense and the use of the Commission's allowed rate of return.

On August 27, 1984, the Commission issued its Notice and Order for Rehearing this case. Rehearing was granted for the limited purposes of receiving the DPS August 1, 1984 Report in *NWB*, P-421/CI-84-192 into the record of this proceeding and determining whether there was cause to go forward to a contested case proceeding regarding the financial impact of NWB's corporate restructuring on this proceeding.

On August 30, 1984, the Commission issued its Order After Reconsideration and Order Approving Compliance Filing in the Intrastate Access Charge Case, Docket No. P-421/CI-83-203 et al. That Order indicated that NWB was entitled to increased gross annual revenues of $382,405 in order to eliminate the revenue deficiency identified in that proceeding. The Order also directed NWB to implement the rate increases from that proceeding within the context of the general rate case compliance filing in this proceeding *NWB*, P-421/GR-83-600.

On September 12, 1984, the Commission held a rehearing to receive the DPS August 1, 1984 Report into the record of this proceeding, and to determine whether there was cause to go forward to a contested case proceeding regarding the financial impact of NWB's corporate restructuring on the proceeding. The following parties appeared at the rehearing: NWB, the DPS, the RUD-AG, MPIRG, Evan J. Henry, and the Department of Defense and the Federal Executive Agencies. None of the parties disputed the accuracy of the $363,000 downward adjustment to the authorized rate increase as set forth in the DPS memorandum of August 24, 1984 or requested further hearings on this matter.

On September 26, 1984, the Commission issued its Order After Reconsideration and Rehearing in this proceeding, *NWB*, P-421/GR-83-600. That Order indicated that the $57,511,000 increase in gross annual revenues authorized in the July 27, 1984 Order should be reduced by $363,000 in order to recognize the test year effects of the Northwestern Bell corporate reorganization.

By letter dated September 17, 1984, Northwestern Bell requested that the revised rates contained in the proposed tariff pages submitted on August 3, 1984 be approved to allow it to collect the revenue increases authorized in the August 30 and the September 26, 1984 Orders.

On September 26, 1984, the Commission sent a letter to all parties in this proceeding soliciting comments regarding NWB's proposed tariff pages and its proposal to implement the rates contained in the August 3, 1984 tariff pages to allow the Company to collect the revenue increases authorized in the August 30 and the September 26, 1984 Orders. The Department of Public Service was the only party to submit comments. The Department of Public Service indicated that it had no objection to Northwestern Bell's proposals.

On October 17, 1984, the Commission issued its Order approving Tariff Pages and Customer Notice in *NWB* P-421/GR-83-600. That Order approved NWB's proposal implementing the rates contained in the August 3, 1984 tariff pages to allow NWB to collect the revenue increases authorized in the August 30 and September 26, 1984 Orders in this proceeding.

On April 9, 1986, the Commision issued its Order Initiating Investigation *In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contracts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners* in Docket No. U-999/CI-86-177. In that Order, the Commission directed the DPS to conduct an independent investigation to assess whether any improper communications occurred during Commission proceedings addressing issues of significant financial impact to regulated companies or addressing significant policy issues likely to lead to a significant financial impact on regulated companies. The Commission directed that the investigation cover at least the last several months of the Commisison terms of former Commissioners Juanita R. Satterlee, Roger L. Hanson, and Leo G. Adams. The Commission could then use this investigation to remedy any improper influence caused by these contacts.

On July 8, 1986, the DPS submitted its "Report of the Department of Public Service to the Minnesota Public Utilities Commission" (the DPS Report) in Docket No. U-999/CI-86-177. The DPS also submitted the depositions and documents it obtained in the course of its investigation as supporting exhibits to the DPS Report. The DPS identified seven decisions which may have been tainted by employment discussions between regulated companies and then-sitting Commissioners and recommended that the Commission reopen the following five decisions: *Intrastate Intercity Telecommunications Services,* Docket No. P-442 et al./NA-84-212 (October 15, 1985) (*Toll Competition* docket); *United Telephone Company,* Docket No. P-430/GR-84-597 (August 12, 1985) (*United* docket); *New Ulm Telecom,* Docket No. P-419/NA-84-334 (March 14, 1986) (*New Ulm* docket); *Northwestern Bell Telephone Company,* Docket Nos. P-421/CI-82-619, P-421/M-83-127, and P-421/M-82-512 (May 16, 1983) (*WATS Resale* docket); and *Northwestern Bell Telephone Company,* Docket Nos. P-421/M-83-144, P-421/M-83-167 (June 1,

1983) (*Basic Six* docket). The DPS Stated that no corrective action was necessary in *Northwestern Bell Telephone Company*, Docket No. P-421/GR-82-204 (April 20, 1983) or *In the Matter of the Acquisition of Peoples Natural Gas Company by Utilicorp United, Inc.*, Docket No. G-011/PA-85-681 (December 4, 1985). The DPS also made five other recommendations which related to actions to eliminate future improper contacts.

On August 13, 1986, NWB filed a response to the DPS Report, asking the Commission to deny the DPS recommendations to reopen the *WATS Resale, Basic Six, New Ulm,* and *Toll Competition* decisions.

On July 9, 1986, the RUD-AG filed a petition requesting the Commission to reopen and reconsider its July 27, 1984, Findings of Fact, Conclusions of Law, and Order *NWB,* P-421/GR-83-600. The petition claimed that this proceeding had been tainted by ex parte communcations between NWB and former Commissioners during deliberations on the case. The DPS Report had revealed these communications. On July 18, 1986, NWB filed its response asking the Commission to deny the RUD-AG petition. On August 1, 1986, the RUD-AG filed a reply brief to NWB's response. On September 15, 1986, NWB responded to the RUD-AG reply brief.

On August 14, 1986, MPIRG filed a petition requesting that the Commission vacate and dismiss its July 27, 1984 and November 13, 1984 Orders in *NWB,* P-421/GR-83-600, for reasons similar to those given by RUD-AG petition. On September 15, 1986, NWB responded to MPIRG's petition, asking that the petition be denied.

On October 3, 1986, the Commission issued its Order Establishing Procedures and Soliciting Briefs in Docket No. U-999/CI-86-177. That Order requested parties to submit briefs on whether *NWB,* P-421/GR-83-600, *Toll Competition, United, New Ulm, WATS Resale, Basic Six* or any other decisions in the relevant time period were tainted due to a conflict of interest of ex parte communications between former Commissioners Adams, Hanson, or Satterlee and regulated companies.

On October 23, 1986, United Telephone Company (United), SRA, MPIRG, RUD-AG, NWB and the DPS filed comments or briefs in Docket No. U-999/CI-86-177. In its brief, the DPS recommended that the Commission re-deliberate this proceeding, *NWB,* P-421/GR-83-600, on the merits. The DPS had not recommended

reopening of this case in its July 8, 1986 Report which focused on the impact of job negotiations, rather than on gratuities and ex parte contacts. On October 24, 1986, the MBUUC filed a letter addressing this matter and U.S. Sprint filed a brief.

On October 28, 1986 the Commission issued its Notice of Oral Argument in Docket No. U-999/CI-86-177.

On November 3, 1986, NWB filed its Reply to the submissions of the other parties in Docket No. U-999/CI-86-177.

Oral argument was held in Docket No. U-999/CI-86-177 on November 6, 1986 with representatives of the DPS, the RUD-AG, MPIRG, the SRA, the MBUUC, AT&T, and NWB participating.

On April 2, 1987, the Commission issued its Order After Investigation in Docket No. U-999/CI-86-177. That Order vacated the Commission's July 27, 1984 Order in this proceeding, *NWB*, P-421/GR-83-600, and directed that this proceeding be redeliberated by the present Commission to remove any possible improper influence on the decisions in the Commisison's July 27, 1984 Order and to restore public confidence and trust in regulation.

The Commission has redeliberated the *NWB*, P-421/GR-83-600 original case record up through replies to exceptions and the transcript of the July 9, 1984 Oral Argument. The Commission did not sulicit or receive new pleadings or argument. Parties are hereby advised that the Commission has adopted some of the express language contained in the vacated July 27, 1984 Order into this Order, particularly when describing the positions of the parties and when the Commission's decisions on redeliberation are the same as its earlier vacated decisions.

Notice is hereby given that pursuant to Minnesota Rules, part 7830.4100 petitions for rehearing or other post-hearing relief, by any party adversely affected, must be filed within 20 days of the mailing date hereof (original plus 13 copies) with Mary Ellen Hennen, Executive Secretary, Minnesota Public Utilities Commission, 780 American Center Building, 150 East Kellogg Boulevard, St. Paul, Minnesota 55101, with proof of service on all parties. The grounds relied upon shall be specifically set forth and the claimed errors clearly stated in the petition. If desired, adverse parties may file and serve answers (original plus 13 copies) within 10 days after service of the petition. The Commission may, in its discretion, grant oral

argument on the petition or may decide that petition without oral argument.

Now upon review of the entire record herein, the Commission makes the following Findings, Conclusions and Order:

FINDINGS AND CONCLUSIONS

I. JURISDICTION

The subject matter of this proceeding is properly within the jurisdiction of the Commission by virtue of Minn. Stat. Ch. 237, and was properly before the ALJ by virtue of Minn. Stat. §§ 14.48–14.56 (1982) and Minnesota Rules, part 1400.5100 *et seq.* The hearings held herein were convened pursuant to proper notice. The Commission has fulfilled all relevant substantive and procedural requirements of law and has the authority to now act.

II. NORTHWESTERN BELL TELEPHONE COMPANY

Prior to January 1, 1984, Northwestern Bell Telephone Company was an Iowa Corporation, wholly owned by its parent corporation, American Telephone and Telegraph Company (AT&T), which provided telephone service in Minnesota, North Dakota, South Dakota, Nebraska and Iowa. The 22 Bell Operating Companies, Western Electirc Company, Bell Telephon Laboratories and the Long Lines Department of AT&T were all integrated units of the Bell Telephone System.

When Northwestern Bell's rate application was originally submitted, the Plan of Reorganization filed by AT&T to effectuate divestiture as a consequence of *United States v. American Telephone & Telegraph Co.*, 552 F. Supp. 131 (D.C. 1983), *aff'd* 103 S. Ct. 1240 (1983), had been approved by the Federal District Court; however, divestiture had not yet taken place.

On January 1, 1984, AT&T divested itself of the Bell Operating Companies (BOCs). Ownership of these companies was transferred to seven new Regional Holding Companies (RHCs). The RHCs are autonomous from each other and from AT&T.

Northwestern Bell Telephone Company, Mountain States Telephone and Telegraph Company and Pacific Northwest Bell Tele-

phone Company are subsidiaries of US West, Inc. (US West), one of the seven Regional Holding Companies resulting from the Plan of Reorganization. US West provides service in fourteen states in the Pacific Northwest, Southwest, Rocky Mountains, and Great Plains regions of the country. US West operates several non-regulated subsidiaries. The estimated combined assets of the subsidiaries comprising US West were $17 billion on June 30, 1983, with projected revenues for 1984 of $7.4 billion.

Northwestern Bell is currently a wholly-owned subsidiary, through an intermediate holding company, of US West and provides telephone service in the same territory both in Minnesota and surrounding states as it did prior to divestiture of the Bell Operating System.

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IV. TEST YEAR

In January of 1982, AT&T and the Department of Justice (DOJ) entered into an agreement to settle an antitrust action commenced by the DOJ against AT&T in 1974. In that settlement agreement, AT&T agreed to a massive restructuring of the Bell System. After protracted proceedings, the United States District Court of the District of Columbia (Divestiture Court) formally approved the settlement in the form of a Modification of Final Judgment (MFJ) on August 24, 1983. One of the major requirements of the MFJ was that AT&T submit a detailed Plan of Reorganization (Plan of POR) which was approved as modified on August 5, 1983, by the Divestiture Court.

On January 1, 1984, the Bell Operating Companies (BOCs), including NWB, were divested from AT&T pursuant to the terms of the MFJ and the POR. As a result of divestiture, the License Contract Agreement with AT&T, the Business Information Systems (BIS) Agreement with Bell Labs, and the Standard Supply Contract with Western Electric were terminated. Under the Plan, assets used solely for exchange telecommunications, exchange access functions, and directory functions were assigned to the BOCs. Conversely, the ownership of customer premises equipment (CPE) and assets used solely for interexchange functions was assigned to AT&T. Assets used to provide both exchange and interexchange functions were assigned on the basis of predominant use. With regard to person-

nel transfers between NWB and AT&T, the fundamental principle of the Plan was that employees followed their work.

As a result of divestiture and the MFJ, NWB has been restricted in the scope of its activities and services. NWB may no longer provide interexchange telecommunications services. NWB may only provide exchange service or service within Local Access and Transport Areas (LATAs), provide exchange access for the purpose of originating or terminating interexchange telecommunications (inter-LATA), and provide directory services.

The Company's test year in this proceeding was based on 1983 actual data adjusted as though the Company had operated on a divested basis throughout 1983. The Company utilized a divestiture overlay approach to restate 1983 actual data. NWB projected 1984 investment, revenue, and expense data on both a pre-divestiture and post-divesture basis and determined a relationship between post-divestitute and pre-divestiture data (divestiture ratios). Those divestiture ratios were applied to actual combined 1983 data to determine post-divestiture operations. Estimated 1984 separation factors were then applied to obtain the intrastate post-divestiture test year data. In developing the divestiture ratios, the Company utilized the Divestiture Guidelines jointly prepared by AT&T and the BOCs pursuant to the MFJ and in compliance with the POR as the basis for determining the split of revenues, investment, and expenses between NWB nad the AT&T entities.

The Company has offered to provide to the Commission a specific intrastate accounting of actual 1984 results, indicating the rate of intrastate return actually realized in the first full post-divestiture year, calculated according to the Commission's own findings. The Company has offered to make appropriate refunds to customers to reduce the earned return for 1984 to the authorized level, in the event that the Company earns in excess of the authorized rate of return during 1984 for intrastate operations.

The RUD-AG advocated that the 1983 test year be presented on a pre-divestiture basis claimng that the divestiture effects incorporated into the revenue requirements of the Company are not known and determinable. The RUD-AG charged that the Company and not adequately supported the reliability of its divestiture overlay procedure and that the Company's refund offer should not be accepted as a substitute for proof.

The DPS recognized that an unadjusted actual 1983 test year cannot be considered representative of NWB's future operations in a post-divestiture environment. Consequently, DPS witness Louiselle presented the test year on a post-divestiture basis. His first approach was to use a modified divestiture overlay approach similar to that used by NWB. He also presented an alternative approach which was based on the assumption that the revenues NWB lost upon divestiture were producing earnings at the same rate as all other intrastate revenues. His second alternative approach assumed that the divested revenues were earning at the same rate as all of NWB's interstate services.

The ALJ found it appropriate to reflect the effects of divestiture on NWB stating that to ignore divestiture would be to ignore reality. The ALJ also found that the general divestiture overlay approach was the most reasonable method of accounting for the effects of divestiture and for determining prospective rates for NWB. The ALJ also suggested that the Commission require the Company to provide periodic reports during the time revised rates are in effect and that the Company should be required to refund to ratepayers amounts earned in excess of its authorized rate of return. He noted that the Company had volunteered to do so with respect to 1984.

The ALJ found that 1983 revenues and rate base could be measured as if divested directly without the use of the estimation factors contained in divestiture ratios. He found that calculations relying on a direct divestiture of assets and revenues demonstrated that the divestiture ratios developed by the company with respect to such items tended to understate the Company's revenue requirements. He also found that 1983 expenses could not be divested directly and that it was appropriate to treat investment, revenues, and expenses with a consistent divestiture overlay technique.

Although the ALJ believed that the process by which the Company developed its divestiture ratios involved a large measure of unverifiable subjectivity, he stated that the Company's direct divestiture of 1983 revenues and investment established the fundamental integrity of the overlay process, at least in regard to revenues and rate base. The ALJ stated that the alternative approach suggested by the Department was not the primary recommendation of its expert witness. The ALJ considered the use of a divestiture ratio overlay approach superior to the alternatives presented by both the

DPS and the RUD-AG.

Although the Company generally agreed with the ALJ's findings, it took exception to Findings 52 and 53, which indicated a lack of evidence and documentation as to how Divestiture Guidelines were applied. The Company pointed out that with regard to investments, the updated divestiture ratios were a direct result of the actual asset transfers to AT&T effective January 1, 1984. The Company stated that the itemization of the asset transfers and Company witness Quinn's workpapers that developed the investment overlay percentages based on those transfers are in the record. In rebuttal testimony, Mr. Quinn presented testimony and workpapers showing that a direct divestiture of 1983 revenues indicated that the use of the overlay process for purposes of estimating revenues was conservative in nature. With regard to expenses, witness Yerger testified that the split of expenses was done by each of the operating organizations that were in the best position to apply the Divestiture Guidelines and determine their operational impacts. The split of expenses was accomplished by assessing the job functions that employees were performing and then determining which entity, NWB or AT&T, will perform that job function after divestiture. Job function codes, location codes, and work/time reports were used to help determine the splits.

The Department excepted to the ALJ's adoption of the Company's divestiture overlay approach as "the most reasonable method of accounting for the effects of divestiture." The DPS stated that there was no way to determine the accuracy of the Company's portrayal of post-divestiture expenses until after December 31, 1984. Thus, the DPS contended that it is impossible to state whether the Company's divestiture overlay approach understates or overstates its revenue requirement. The DPS argued that its alternative approaches are no more subjective or verifiable than the Company's overlay approach but are equally defensible.

The RUD-AG decided not to except to ALJ's rejection of its position. The RUD-AG stated that the ALJ's acceptance of divestiture ratios in a disaggregated form as adjusted by the DPS and his acceptance of various adjustments proposed by the DPS and RUD-AG resulted in a reasonable approach to this unique and complex issue.

The Commission is in general agreement with the findings,

rationale, and recommendations of the ALJ that the effects of divestiture should be recognized in this proceeding and that a divestiture ratio overlay approach should be utilized to measure the divestiture effects. The Commission agrees that the Company's direct divestiture of 1983 revenues and investment, as indicated in its rebuttal testimony, substantiated the reliability of the overlay process as it relates to revenues and rate base.

The Commission also agrees that the Department's alternative approach was not the primary method sponsored by its expert witness. Very few pages of Mr. Louiselle's supplemental and surrebuttal testimony relate to his two alternative approaches. The revenue loss in his alternative approach was based on a comparison of 1983 intrastate revenue on a pre-divestiture and post-divestiture basis. The post-divestiture revenue used in that comparison was the final revenue number calculated by Mr. Louiselle in his divestiture overlay approach after *pro forma* adjustments. Thus, the divestiture overlay process was utilized to determine the revenue loss in the DPS alternative approach. The Commission believes that the rate base after divestiture can more accurately be determined by use of an overlay approach that is based on the actual asset transfer that occured than by arbitrarily calculating the divested rate base as a function of revenue loss.

The Commission concludes, as did the ALJ, that the use of the divestiture ratio overlay approach to account for the effects of divestiture is superior to the alternatives presented by both the DPS and the RUD-AG. The Commission will determine whether to use aggregated or disaggregated divestiture ratios as it considers rate base, revenues, and expenses.

The ALJ recommended that the Commission require the Company to report on a periodic basis its activities during the period of time within which the revised rates remain in effect as a check against the accuracy of the divestiture ratios used in this proceeding. He further recommended that the Commission should require the Company to refund or credit to ratepayers amounts earned in excess of its authorized rate of return. This recommendation was prompted, in part, by NWB's voluntarily offering to make such refunds or credits with respect to 1984.

While the Commission would encourage the Company's voluntary efforts to refund rates that are shown to be excessive when

the haze of divestiture is removed and the actual results are known, the Commission has given little weight to such a refunding proposal since there is no way to enforce such a proposal. Final rates determined as a result of this case are just that—final rates. As the Commission has recently noted in *Continental Telephone Company*, Docket No. P-407/GR-83-294 (May 14, 1984), p. 2:

> Rate making proceedings have reasonably finite time limits. Indefinite and unknown contingencies should not cloud the Commission's determination of this issue [interest imputed to JDIC portion of rate base] in this case. The Commission also finds that RUD has not shown that Minn. Stat. § 237.075 (1983) provides the Commission authority to make final approved rates subject to refund as proposed by the RUD.

Once final rates are established, the Commission recognizes that it could lower those rates only prospectively after affording the Company the opportunity for hearing. While the Commission encourages the Company to follow through with its undertaking to refund, its decision on this issue has been made upon the record before it and is not based upon the refunding offer.

However, the Commission concludes that the Company should be required to file intrastate financial results each quarter on a calendar year to date basis and for the 12 month period ending each quarter. The reports should continue as long as the rates established in this proceeding remain in effect.

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2. Capital Structure and Cost of Debt

Mr. Bauhard

Mr. Bauhard initially recommended that the Commission adopt NWB's projected post-divestiture capital structure as of 1/1/84. He felt that NWB's capital structure had become the most appropriate means to determine the overall fair rate of return in this proceeding because he no longer relied on AT&T's cost of equity to estimate NWB's cost of equity. This recommendation was a change from the recommendation he made in NWB's previous rate case, *NWB*, Docket No. P-421/GR-82-203, where he recommended that

the Commission use the Bell System consolidated capital structure. He felt that the focus on NWB rather than AT&T recognized the effects of divestiture.

Mr. Bauhard began the determination of his recommended capital structure for NWB by first taking the capital structure for NWB at 12/31/83 which consisted of $1.259 billion long term debt, approximately $53 million short term debt and approximately $2.273 billion common equity for a total of $3.585 billion capital. This resulted in a capital structure for NWB at 12/31/83 of approximately 36.6% debt and 63.4% equity.

To determine a projected actual capital structure for NWB as of January 1, 1984, Mr. Bauhard estimated that NWB, at divestitue, would transfer approximately $441 million of its equity to AT&T. The Company would also require additional short term debt financing of approximately $27 million on January 1, 1984. This combined with the $53 million in short term debt as of 12/31/84 would result in about $80 million in short term debt financing for NWB as of 1/1/84. If Mr. Bauhard's estimates were correct, NWB would have $1.832 billion equity and $1.339 billion debt as of January 1, 1984. The resulting debt to equity ratio would be 42.2% debt and 57.8% equity. Mr. Bauhard argued that this capital structure would barely meet the standards for the Triple A debt rating NWB enjoyed prior to the divestiture.

In his written rebuttal testimony, Mr. Bauhard updated his recommendation for NWB's capital structure to reflect the fact that NWB transferred approximately $23 million in equity to US West for directory advertising on January 3, 1984. This transfer was financed with $23 million in short term debt. As his final recommendation, Mr. Bauhard urged the Commission to adopt NWB's actual capital structure as of January 3 1984 which contained 43.6% debt and 56.4% equity.

During his oral rebuttal testimony, Mr. Bauhard mentioned that NWB planned to issue $150 million in long term debt in March 1984. The Company did not recommend any changes in its proposed actual capital structure to reflet the issuance of this debt.

NWB originally projected an embedded cost of debt for NWB of 7.8% as of January 1, 1984. This cost of debt figure was updated to 7.93% in Mr Bauhard's rebuttal testimony to correspond with NWB's actual capital structure as of January 3, 1984. In oral

rebuttal testimony, Mr. Bauhard mentioned a planned long-term debt issue of $150 million by NWB at an interest rate in the range of 13.50% to 13.25%; he claimed the debt issue would raise NWB's embedded cost of debt ot 8.5%. In oral testimony, Dr. Litzenberger stated that NWB issued the $150 million debt at a cost of 13.69% in March 1984. In its brief, NWB recommended using an 8.5% embedded cost of debt.

Mr. Meyer

Mr. Meyer described the financial policies and results necessary for NWB and its parent, US West, to maintain access to the long term credit markets and the quity markets on reasonable terms.

Mr. Meyer examined the coverage ratio and capital structure requirements on long term bond investments as indicated by bond rating agencies. He measured the advantages and disadvantages of various bond ratings to NWB both in terms of cost to the ratepayer and financial flexibility to the Company. In addition, he discussed the importance of stock price to the financibility of US West and its operating companies and, in turn the importance of earning a rate of return on equity and utilizing a dividend policy which would enable US West to achieve net proceeds of not less than book value when issuing new common stock.

Mr. Meyer presented the minimum financial requirements of companies necessary to maintain credit ratings at various levels as stated by Standard & Poor's and as followed by Duff and Phelps, and Moody's.

Mr. Meyer felt that it was essential for NWB to maintain a capital structure consistent with triple A and double A ratings to raise additional increments of debt capital in the future.

Mr. Meyer also felt that it was critical that US West adopt a dividend policy necessary to provide a market-to-book ratio of at least 120% and hopefully more. To do this Mr. Meyer felt that it was necessary to have a dividend-to-book ratio of 10.25% to 10.50% and a payout ratio of 66-2/3%. He felt that this dividend policy combined with investor expectations of a growth rate in earning per share of 6.9% to 8.6% per annum should produce a minimum market-to-book ratio of 120%.

In the future, if US West engaged successfully in non-regulated business, Mr. Meyer felt that there should be the opportunity to

enhance the market-to-book ratio of the Company, thereby lowering the cost of capital. If the Company was able to issue its new common stock at net proceeds above book value, then the growth rate necessary to attract investors was enhanced and the rate of return on equity necessary to achieve competitive total return declined.

Mr. Meyer argued that if the Commission adopted Dr. Thompson's hypthetitcal capital structure, and then it was subsequently adopted by the Company, the Company's bond rating would be, in all probability, downgraded. As a result, the cost of capital would increase and the availability of new capital would decrease.

Dr. Thompson

Dr. Thompson recommended that a hypothetical capital structure be used for NWB which consisted of 42.2% debt, 7.8% imputed debt, and 50.0% common equity.

Dr. Thompson argued that the reasonableness of a capital structure for regulatory purposes must be based upon objective benchmarks. He felt that a useful benchmark was an average capital structure for a group of comparable companies.

Dr. Thompson felt that the determination of the actual capital structure of a company was the prerogative of management. However, for regulatory purposes, he argued that it was the Commission which must decide what capital structure is fair and reasonable to use in determining the overall allowed rate of return to be earned on the utility's rate base. Dr. Thompson felt that the determination of a operational capital structure from an accounting perspective for a utility as a subsidiary of a diversified company was primarily a decision for company management, but where it was appropriate and necessary, the Commission could impose or impute a capital structure different from a company-proposed capital structure when it was reasonable to conclude that the proposed capital structure was inappropriate for regulatory purposes.

Dr. Thompson argued that the determination of that capital structure should be made using references to industry comparisons based upon risk relationships and industry averages to determine appropriate benchmarks. Although the Company management had the responsibility of establishing an operational capital structure for a subsidiary, the reasonableness and safety of that imputed capital

structure for regulatory purposes rested with the Commission.

Dr. Thompson based his imputed or hypothetical capital structure upon a review of several comparable groups. He considered this a reasonable balance between investors' and consumers' interests. He started with NWB's projected capital structure on 1/1/84 and compared its projected common equity ratio (57.8%) with common equity ratios of comparable groups.

One of his comparable groups consisted of the companies used by Dr. Amit in his cost of common equity analyses. A second and third group were selected based on the testimony of Mr. Bauhard and Mr. Morris, and two additional groups were those used by Dr. Litzenberger. Dr. Thompson also looked at the capital structure used in the last NWB rate cae which contained 50.1% common equity.

Dr. Thompson determined his recommended 50% equity ratio by looking at the most recent common equity ratios for the comparable groups. The common equity ratios for these companies ranged from a high of 61.69% (Cincinnati Bell) to aq low of 33.54% (Mid-Continent). For a AA regulated company he felt that a 50% equity ratio was appropriatge for ratemaking purposes.

Dr. Thompson treated the difference between his proposed 50% equity ratio and the company proposed 57.8% equity ratio as a separate type of capital and assigned to it a current average cost of AA rated debt. AA was the current rating of NWB and was similar to ratings for comparable groups of companies.

Based on his analysis and regulatory considerations, he believed that his recommended capital structure was a reasonable estimate for NWB Minnesota's capital structure for regulatory purposes during the current regulatory period.

With regard to the cost of debt, Dr. Thompson felt that 7.8% was a reasonable estimate for the average embedded costs of long term debt for NWB during the current regulatory period. He felt it was consistent with the use of his proposed capital structure. In addition, he believed that the current cost of debt of 12.8% (average from November 1982 to October 1983) contained in Moody's November 1983 bond record for a AA rated utility was a reasonable estimate for regulatory purposes for the excess portion of the common equity he proposed be treated as a separate form of debt (imputed debt.)

Dr. Thompson recommended an overall rate of return for NWB of 11.51% using the 7.8% return on long term debt, 12.8% return on imputed debt and 14.46% on common equity.

In its Proposed Findings of Fact and Conclusions of Law, the DPS revised Dr. Thompson's recommendations to reflect updated numbers. The DPS's final recommendation consisted of 43.6% debt (at an 8.5% cost, increased from the previous 7.93% to reflect the issuance of $150 million in long term debt), 6.4% imputed debt (at a 12.83% cost) and 50% equity (at a 14.46% cost) for an overall cost of capital of 11.76%.

Dr. Marcus

Dr. Marcus testified that the appropriate capital structure should match the entity on which the cost of equity is being based. In this proceeding, he recommended the use of US West on which to base the cost of equity and therefore argued that US West's consolidated capital structure should be used to determine NWB's overall rate of return. US West's consolidated capital structure as of 1/3/84 contained 44.06% debt and 55.94% equity. According to the Company, this capital structure reflected only the consolidated operations of US West's regulated entities, which included NWB, Pacific Northwest Bell, and Mountain States.

Prior to market data being available on US West, Dr. Marcus initially recommended a capital structure containing 45% debt and 55% equity. He employed several guidelines to determine his appropriate capital structure for NWB. These were (1) the capital structures employed by other utilities, (2) the capital structure trends for the Bell System, and (3) the capital structure standards set forth in the Consent Decree.

To observe the capital structure employed by other utilities, Dr. Marcus considered all Aa-rated electric utilities. These utilities averaged a 39.8% common equity ratio. He also considered the common equity ratios of non-Bell telephone utilities. Their average equity ratio was 52.5%. He also reported the financial statistics for another group of telephone companies with significant non-telephone sources of revenues and noted that the average common equity ratio for the group was only 41.7% but that their bond rating was generally weaker (Baa). Finally, he noted that the trend in AT&T's capital structure was of interest.

It was apparent to Dr. Marcus that the Bell System's common equity ratio had been quite stable at about 50% from 1978 through 1980, but had since displayed a sharp increase. Dr. Marcus stated that AT&T's 1982 common equity ratio of 55.6% already represented a rise of 500 basis points in just two years. He said this increase had been justified by AT&T citing the rise in competitive risks.

His initial conclusion that the Commission base its authorized overall rate of return on a capital structure containing 55% common equity and 45% debt was based on the following considerations:

1. NWB's proposed capital structure with 57.8% equity and 42.2% debt was a projection. The actual ratio upon divestiture might differ depending on the actual amount of assets transferred to AT&T.
2. A 55% equity level was significantly higher than the common equity ratio of high grade electric utilities (Aa bond rating).
3. A 55% equity ratio was consistent or higher than the capital structure of non-Bell telephone companies.
4. The 55%–45% mix already reflected the enormous rise in the Bell System's common equity accomplished between 1980 and 1982.
5. The 55%–45% mix was the standard set in the Consent Decree.
6. US West was a new business entity for which no direct risk measures were yet available. A decision to authorize a higher Ratio than 55% should be made only based on explicit evidence.

In its Proposed Findings of Fact and Conclusions of Law, the RUD-AG presented its final recommendation as to the appropriate capital structure for NWB and the resulting overall rate of return. The RUD-AG argued that the evidence in this case supported an overall rate of return of 11.60% based on a capital structure containing 44.06% debt and 55.94% common equity, with the cost of debt being 7.93% and the rate of return on equity capital being 14.5%.

This final recommendation was a result of Dr. Marcus' further testimony that US West's consolidated capital structure should be used as the appropriate capital structure for NWB.

With regard to the cost of debt, Dr. Marcus agreed with Mr. Bauhard's initial updated recommendation of 7.93% as the actual

embedded cost of debt for NWB. The RUD-AG did not subsequently accept, however, NWB's revised cost of debt of 8.5%, arguing that it was not adequately supported by record evidence. The RUD-AG argued that NWB's proposed embeded cost of debt of 8.5% should be rejected by the Commission, because it was unclear what the cost of the March debt issue was to NWB and what effect the issue had on NWB's embedded cost of debt. The RUD-AG contended that if the Commission were to take the debt issue into account, then the proposed capital structure must be revised to reflect the addition of the new debt.

The Administrative Law Judge

The ALJ found that NWB did not sustain the burden of proof that the actual capital structure of the Company was appropriate for regulatory purposes. Based on this finding, he determined it was appropriate to attribute to NWB a hypothetical capital structure based on objective tests of propriety.

To determine his hypotheticial capital structure, the ALJ took into consideration several different observations on regulated companies' equity ratios. He determined an average equity ratio of 45.65% for five groups of companeis selected by the parties as comparable to NWB and found that figure provided an objective benchmark in judging the capital structure to be assigned to NWB for regulatory purposes. He also determined that the weighted average authorized common equity ratio for regulatory purposes of US West's regulated telephone operations was 51.58%. He found as a consequence of his considerations that it was appropriate to retain the common equity ratio of 50.1% authorized in the NWB's last general rate case. The ALJ determined that the appropriate hypothetical capital structure contained 50.1% common equity and 43.6% debt, and 6.3% additional debt.

The ALJ recommended that the embedded cost of debt was 8.5%. This reflected the addition of a $150 million debenture issue at a cost of 13.69% during the week of March 18, 1984. He assigned the latest 12 month average cost of debt, 12.83%, to the 6.3% imputed debt he included in the Company's capital structure.

The ALJ recommended that the Commission authorize an overall rate of return for NWB of 11.76% based on a capital structure

that included 50.1% equity (at a 14.46% cost), 43.6% debt (at a 8.5% cost), and 6.3% imputed debt (at a 12.83% cost).

C. Commission Findings and Conclusions.

Introduction

In this proceeding, the Commission was presented with a difficult task regarding the determination of a fair and reasonable rate of return on equity for NWB, the selection of an appropriate capital structure and the determination of the cost of NWB's debt in a post-divestiture environment. In the past, the Commission has determined the capital structure and rate of return for AT&T and applied the results to NWB, which prior to divestiture was a wholly-owned subsidiary of AT&T. The Commission finds that, because of the divestiture, it is no longer reasonable to use AT&T as a proxy for NWB.

The difficulty of the task of determining an appropriate rate of return was exacerbated by the lack of reliable evidence in the post divestiture period in terms of the evidence's substance and historical perspective upon which the Commission could base its decisions. The transfers of equity to AT&T, a consequence of divestiture, the transfer of equity to US West, a post-divestiture transaction to reflect the transfer of the Yellow Pages advertising operation and telephone directory operations, and the issuance of debt to finance such transfers further confused and complicated the record because no concrete data was presented by the Company regarding such transfers.

NWB does not issue common stock to the public; its common stock is all held by its parent company, US West. The Commission agrees with the ALJ that there is insufficient historical and market data available on the equity of US West and the other regional holding companies to justify placing primary reliance on a DCF analysis of these entities to determine a fair and reasonable rate of return for NWB in this proceeding. Therefore, an appropriate proxy group of companies must be used. Commission will rely upon the DCF analysis of comparable-risk telephone companies performed by DPS witness Amit as the primary method for determining the return on equity to be allowed NWB.

The Commission also agrees with the ALJ that neither the post-divestiture capital structure of NWB nor that of US West is appro-

priate for regulatory purposes in this proceeding. Therefore, the Commission must impute an appropriate capital structure for rate-making purposes. The Commission will rely primarily on the analysis DPS witness Thompson, as modified slightly by the ALJ, to make this determination.

The Commission will adopt the ALJ's conclusions that a reasonable rate of return on equity for NWB is 14.46%; that the appropriate capital structure for determining the overall cost of capital consists of a common equity ratio of 50.1%, embedded debt of 43.6%, and imputed debt of 6.3%; and that the appropriate cost of the imputed debt is 12.83%. The Commission will use a cost of embedded debt of 8.22%, rather than the 8.50% employed by the ALJ, because the 8.50% is not adequately supported in the record. The resulting Commission-allowed overall return for NWB is 11.63%.

The Commission will discuss below in more detail its findings and conclusions with respect to NWB's cost of equity, the appropriate capital structure to utilize in determining the overall rate of return to NWB and the cost of debt.

Return on Common Equity

As an administrative agency, the Commision must act both within the scope of its enabling legislation and the strictures of reviewing judicial bodies. Two United States Supreme Court cases provide these general guidelines for Commission rate of return decisions:

1. The allowed rate of return should be comparable to that generally being made on investments and other business undertakings which are attended by corresponding risks and uncertainties.

2. The return should be sufficient to enable the utility to maintain its financial integrity.

3. The return should be sufficient to attract new capital on reasonable terms.

Bluefield Water Works & Improvement Co. v. P.S.C., 262 U.S. 679 (1923), *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

No particular method or approach for determining a rate of return was mandated by those cases, but the necessity of a fair and reasonable rate of return was clearly stated:

> Rates which are not sufficient to yield a reasonable

> return on the value of the property used, at the time it is being used to render the service, are unjust, unreasonable, and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment. *Bluefield Water Works*, 262 U.S. at 690.

The Minnesota Supreme Court's latest decision on rate of return was stated in *Minnesota Power & Light Company v. Minnesota Public Service Commission*, 302 N.W.2d 5 (Minn. 1980). The Court stated:

> . . . The single term "ratemaking" has been used to describe what is really two separate functions — (1) the establishment of a rate of return, which is a quasi-judicial function, and (2) the allocation of rates among classes of utility customers, which is a quasi-legislative function.
>
> . . . we now hold that the establishment of a rate of return involves a factual determination which the court will review under the substantial evidence standard.

302 N.W.2d at 9.

In conducting its evaluation of the Commission's decision, the Court explained:

> . . . A reviewing court cannot intelligently pass judgement on the PSC's determination unless it knows the factual basis underlying the PSC's determination. Judicial deference to the agency's expertise is not a substitute for an analysis which enables the court to understand the PSC's ruling. Henceforth, we deem it necessary that the PSC set forth factual support for its conclusion. The PSC must state the facts it relies on with a reasonable degree of specificity to provide an adequate basis for judicial review. We do not require great detail but too little will not suffice.

302 N.W.2d at 12.

In order to provide the factual basis for its decision required by the Court, the Commission has reviewed the testimony of each of the parties on rate of return on common equity, the objections raised thereto by other parties and the recommendation of the ALJ. Based on that review, the Commission makes the following findings with regard to a fair rate of return for NWB's common equity:

All witnesses testifying to the rate of return on common equity utilized the DCF method as their primary method. The Commission finds that the DCF method is the appropriate method for estimating NWB's cost of equity. This method is a market-oriented, opportunity cost approach which views the relationship between the cost of equity, investor's income expectations and market price in a theoretically sound and systematic manner. Using the DCF method, an analyst may infer the rate of return investors implicity require of a particular equity investment. Under the DCF theory, the return expected by investors is the sum of the expected dividend yield of the stock and the expected growth in dividends.

NWB does not issue common stock to the public. All of its common stock is ultimately held by a parent company, formerly AT&T and now US West. It is, therefore, impossible to use a market based method of analysis to determine a cost of equity directly for NWB in general or for its Minnesota operations in particular. As a result a proxy must be used to determine a fair cost of equity capital for NWB. Previous determinations of the cost of equity capital for NWB have relied primarily upon a DCF analysis of its then parent, AT&T, adjusted for differing business risks. The Commisison finds that, as a result of divestiture, it is no longer appropriate to use AT&T adjusted for differing business risks. The Commission finds that, as a result of divestiture, it is no longer appropriate to use AT&T as the primary proxy for determining the return on equity to be allowed NWB. AT&T and NWB may not be risk-comparable since AT&T will be involved mainly in the long-distance market and non-regulated business activities, while NWB's activities will be primarily in regulated local service and exchange access service.

NWB placed primary reliance on a DCF analysis of US West and the RUD-AG relied mainly on an analysis of all the regional holding companies. In theory, US West may be a good proxy for

NWB, since it is the parent company of NWB and is the entity through which shareholders may own stock; the other regional holding companies may also be reasonable proxies, since they should be attended by similar business risks as US West. However, the Commission agrees with the DPS and the ALJ that there is insufficient historical and market data available for US West and the other regional holding companies in this record to allow placing primary reliance on such data for determining the cost of equity for NWB in this proceeding.

Trading in the stock of the regional holding companies began on a "when-issued" basis only on November 21, 1983 and regular trading did not start until mid-February, 1984. These companies have not declared or paid dividends; Dr. Litzenberg and Dr. Marcus had to rely on estimates of 1984 dividend from AT&T's November 1983 Information Statement and Prospectus in their DCF analyses. In addition to the lack of dividend and stock price history for the regional holding companies, the irregularities and uncertainties accompanying the market trading of US West stock to date identified by Dr. Litzenberger and Mr. Morris during cross-examination show that US West data is not a reliable basis for estimating NWB's cost of equity. These market trading uncertainties include substantial jumps in stock prices from one day to the next due to large blocks of stock changing hands and margin requirements imposed upon institutional investors by the New York Stock Exchagne. Hence, the Commission finds that primary reliance should not be placed on the limited market data available for US West and other regional holding companies in a DCF analysis for determining the cost of equity to NWB. Therefore, some other more appropriate proxy must be used.

The Commission finds, as did the ALJ, that the appropriate proxy group to use in the DCF analysis is the comparable telephone group used by DPS witness Amit. This group consisted of Cincinnati Bell, Mid-Continent Telephone (subsequently AllTell), Rochester Telephone, and Southern New England Bell. Dr. Amit insured that the proxy group was fairly selected by starting with all companies listed in the Value Line Investment Survey which are classified by the Standard Industrial Classification as primarily engaged in furnishing telephone service and then eliminating companies with more than 20% non-telephone revenue; companies

whose primary business is long distance, rather than local service; and AT&T which, at the time of the original analysis, was not yet primarily a long distance company. The Commission finds that this proxy group is risk-comparable to NWB, based on type of business activity and objective risk measures.

The Commission also agrees with the ALJ that the result of the DCF analysis of Dr. Amit, using the comparable group described above, provides an appropriate and reasonable estimate of the rate of return on equity for NWB. Dr. Amit's analysis developed a dividend yield of 7.70% and a growth rate of 6.76%, resulting in a cost of equity of 14.46%. The reasonableness of this result is confirmed by several other DCF analyses.

Dr. Amit examined the yields of his comparable group companies for the four quarters of 1983. He used the average of the yields for the last two quarters of 1983 for each of the companies, adjusted for expected dividend growth, to derive his average dividend yield of 7.70%. The Commission finds the period used to calculate this dividend yield provides a reasonable estimate of the current yield period, without being so short as to be strongly affected by possible short-term aberrations in the capital markets.

Dr. Amit thoroughly analyzed the expected growth rates for each of the four companies in his comparable group. He examined the five and ten year growth rates in earnings, dividends, and book value per share, using both log-linear and compound (Value Line) growth rates, as well as internal growth rates. He concluded that the following growth rates were appropriate: Cincinnati Bell, 6.71%; Mid-Continent, 6.58%; Rochester, 7.10%; and Southern New England, 6.65%. The average growth rate was 6.76%. The Commission finds that Dr. Amit's growth rate analysis properly examined the major financial and economic variables affecting expected future growth for his proxy companies, and provides the most reasonable estimate of the growth rate likely to be expected by investors.

Based on Dr. Amit's analysis, the Commission concludes, as did the ALJ that the fair and reasonable cost of common equity to NWB is 14.46%. The Commission finds a 14.46% rate of return allowance will allow the Company to maintain its financial integrity and attract new capital on reasonable terms.

The Commission finds that no adjustment to the cost of equity allowance for market breaks, market pressure, or issuance costs is

necessary or appropriate in this proceeding. It would be highly inappropriate to increase the equity return allowance to provide a cushion to investors for possible declines in general market conditions (market breaks), since the risk of market fluctuations is inherent in all equity investments and thus already reflected in the return required by investors measured in the DCF method. The Commission agrees with the DPS, RUD-AG, and ALJ that no adjustment for market pressure or issuance costs is reasonable in this proceeding because US West has no plans for general public issuance of common stock. According to AT&T's Information Statement and Prospectus, US West's capital requirements will be met through debt issues and existing stock plans.

As discussed previously, the lack of adequate market trading data precludes placing primary reliance on US West or the other regional holding companies as proxies for NWB; however, such an analysis, if properly conducted, could provide a secondary check on the previously accepted anlysis. The Commission finds that the results of Dr. Marcus' reasonableness of the 14.46% cost of equity for NWB.

Dr. Marcus used the most representative and reliable data which does exist for the regional holding companies to derive his cost of equity estimate of 14.50%. the results for the regional holding companies as a group used by Dr. Marcus, rather than the results for US West alone, are less prone to be influenced by error and market imperfections that may occur for any one particular company.

Another broad check on the primary DCF results is provided by Dr. Amit's DCF analysis of 19 electric companies and 83 gas and electric utilities. The Commission finds that the 14.15% and 14.25% costs of equity for these groups, respectively, confirms the reasonableness of a 14.46% return on equity for NWB. Gas and electric utilities have generally had a cost of equity capital somewhat below that of telephone companies due to perceived risk differences.

Based on the above discussion, the Commission concludes that a 14.46% rate of return on equity for NWB in this proceeding is appropriate. The Commission will next further discuss its reasons for not relying on the other rate of return analyses presented.

Dr. Litzenberger, in his supplemental testimony, presented a DCF analysis on US West. The Commission rejects his analysis because

it was based primarily on US West alone and the analysis itself was flawed. The Commission has acknowledged that the data on the Bell regional holding companies is limited. Because of the lack of historical perspective, particular abberations associated with US West are likely to be heightened.

Another flaw in Dr. Litzenberger's DCF testimony was his reliance on security analysts' forecasts to determine an expected growth rate. The Commission has consistently rejected the use of analysts' forecasts as an appropriate method for determining the growth rate as in *NWB*, P-421/GR-82-203. Investment reports frequently offer differing dividend and earnings growth rates, and employ different periods of observation. The methodology underlying their estimates and the use which the analysts make of their estimates are also not uniform. Finally, Dr. Litzenberger did not provide any evidence that the analysts he cited are representative of the universe of analyst reports relied upon by investors.

Mr. Morris' DCF analysis leaves the Commission as bewildered as the ALJ as to how Mr. Morris determined his growth estimate. His recommendation was based heavily upon projections from various sources for growth in the general economy and in the firms which made up his composit group, without accompanying evidence in the record regarding the source of such projections or the viability of the assumptions contained in them. This reason alone would be sufficient for the Commission to reject Mr. Morris' DCF analysis. In addition, Mr. Morris, like Dr. Litzenberger and Mr. Bauhard, used an unreasonably short period for measuring his dividend yield, which was not reflective of the yield likely to be expected by investors for the regulatory period.

The DCF analysis of Mr. Bauhard is rejected in part because of his inappropriate use of analysts' forecasts for his DCF growth component, for the same reasons discussed by the Commission with respect to Dr. Litzenberger's testimony. In addition, the group of electric utilities used by Mr. Bauhard is not sufficiently risk-comparable to NWB to be relied upon as a primary proxy for NWB.

The Commission rejects Dr. Smith's DCF analysis. The Commission can not rely on Dr. Smith's individual growth rate estimates for the companies in his comparable group because, as Dr. Smith acknowledged in his oral testimony, the individual estimates could

not be considered appropriate for each of the respective companies. The Commission agrees with the ALJ that the large variations in Dr. Smith's individual growth estimates make the results produced by averaging unreliable, and greatly influenced by the composition of the group.

Mr. Morris and Dr. Litzenberger also relied on variations of the risk premium method as secondary methods of analysis. The two main difficulties with the application of a risk premium approach are the need to find firms of comparable risk to the utility in question and the need for a quantifiable and reasonably stable risk premium. The Commission finds that the analyses of Dr. Litzenberger and Mr. Morris do not provide reliable guides to NWB's cost of equity.

Mr. Morris utilized a conventional risk premium analysis. This method attempts to measure the additional return required by investors in common stock compared to investors in government bonds. The Commission finds that Mr. Morris did not overcome the difficulties associated with the use of the risk premium analysis. He did not demonstrate that the average market risk premium was reasonably stable. The Commission is convinced after reviewing Dr. Amit's exhibit showing various expected risk premiums that the determination of a risk premium value varies depending upon which riskless asset is used to compare with stock returns. Dr. Amit's exhibit also demonstrated that the value of the risk premium is not stable over the years and can vary by as much as 8 percentage points (the risk premiums observed between the years 1951 and 1981 based on U.S. Bonds, A-rated industrials, AAA-rated industrial and AAA composite).

Dr. Litzenberger used a form of the capital asset pricing model (CAPM), which he characterized as a variant of the risk premium approach. The Commission finds that the CAPM exhibits some of the same shortcomings as the traditional risk premium approach in tht the market risk premium is quite volatile and the yield on Treasury Bills or bonds is also subject to rapid change. For example, Dr. Litzenberger's original cost of equity estimate using the CAPM ws 17.7% (a combination of the 12.1% yield to maturity on government debt reported on August 8, 1983 and an estimated risk premium of 5.6%). His updated cost of equity estimate four months later was 17.1% utilizing the same CAPM method and the

5.6% risk premium. The yield on the riskless asset, twenty year government debt, had dropped to 11.8% (as reported on January 17, 1984).

The Commission finds the results of the CAPM and risk premium analyses in this record to be unreliable as guides for determining the appropriate return on equity for NWB.

Capital Structure

The selection of a capital structure is a major element in the determination of rates and slight variations in the capital structure adopted for regulatory purposes may have significant impacts on a Company's revenue requirements. The capital structure is a financial concept which represents the sources of capital to the Company. Conceptually, the problem for the Commission is to identify what the two major sources of capital, debt and equity, are appropriate for ratemaking purposes, to the best interests of the Company and its ratepayers.

The Commission is charged with determining the most reasonable capital structure for NWB for ratemaking purposes. The Commission's ultimate obligation is to set fair and reasonable rates. To accomplish this, ratepayers can only be charged rates based on a reasonable capital structure. In making that determination, the Commission must balance the needs of ratepayers for economy and investors for safety. The effective cost of debt to a company is substantially lower than its cost of equity because the interest rates required by debt-holders are generally less than the return required by stockholders and because interest expense is tax deductible. Beyond some point, increases in the debt ration may lead to increased financial risk for the company. Within reasonable bounds, however, the higher the proportion of debt in the capital structure (and, correspondingly, the lower the proportion of equity), the lower the overall cost of capital is to ratepayers.

NWB has the burden of demonstrating by competent evidence that the capital structure it proposes is reasonable and appropriate. Minn. Stat. § 237.075, subd. 4 (1983 Supp.). The Commission agrees with the ALJ that the Company has mischaracterized its burden of proof in this proceeding. NWB asserts that it does not have the burden of proving that its capital structure is reasonable and prudent. Rahter, NWB contends that the intervenors must

show, and the Commission must find, the Company's actual capital structure to be unreasonable and imprudent before a hypothetical capital structure may be imputed for ratemaking purposes. The Company relies in large part on the court decision in *Northwestern Bell Telephone Company v. State*, 299 Minn. 1,216 N.W. 2d 841 (1974). The Commission disagrees with the Company's assertions and finds that *NWB v. State* does not create a substantial presumption in favor of the capital structure proposed by the Company.

The Commission addressed this issue in its decision in *Central Telephone Company*, Docket No. P-405/GR-83-300 (March 30, 1984) at 26, wherein it stated:

> The Company has the ultimate burden of proving that the capital structure it proposes is appropriate and reasonable. Minn. Stat. § 237.075, Subd. 4 (1982). The Commission establishes the following procedure for determining the appropriate capital structure:
>
> 1. The Company has the burden of coming forward and establishing by competent evidence a proposed capital structure.
> 2. A rebuttable presumption arises that the Company's proposed capital structure is reasonable and appropriate.
> 3. Other parties have the burden of going forward with evidence to rebut or meet the presumption that the proposed capital structure is appropriate. This burden does not shift to other parties the Company's burden of proof.
> 4. The risk of nonpersuasion or ultimate burden of proof remains with the Company. Therefore the Company must meet or rebut contrary evidence or the presumption of appropriateness of the Company's proposed capital structure ceases to exist.

NWB argued that applying the above procedure would be a substantive departure from *NWB v. State*. The Commission disagrees.

In its May 31, 1984 Order denying Reconsideration in *Central*, P-405/GR-83-300, the Commission made it clear that "the procedure is a mechanism used for the purpose of establishing which

party has responsibility for going forward with the evidence." The Commission further stated that the procedure was derived from Rule 301 of the Minnesota Rules of Evidence regarding evidentiary presumptions. The Commission viewed the four-step procedure as not varying or changing the manner in which it selected the most appropriate capital structure for ratemaking purposes.

In a typical general rate case the Commission will receive several proposals regarding the appropriate return on equity and capital structure. The Commission does not engage in a mechanical analysis when it evaluates these proposals as may be suggested by the four-step procedure. The Commission must sift through the evidence supporting these proposals to determine which is the most reasonable for ratemaking purposes. To arrive at a reasonable result the Commission may adopt one of the proposals or parts of several proposals. Flexibility is essential to the Commission's evaluation of capital structure and return on equity. Any interpretation of the four-step procedure which limits the Commission's flexibility is in error.

The Commission did not intend to create by the four-step procedure a substantive or legal presumption in favor of a company-proposed capital structure. A substantive presumption would unnecessarily restrict the Commission's flexibility and place primary focus on only one of the proposals. In addition, a substantive presumption would be inconsistent with the requirements of Minn. Stat. § 237.075, subd. 4 (1982) which places the burden of proving the reasonableness of a proposed change in rates upon the telephone company.

Therefore, the Commission finds this procedure does not make the substantive changes which the Company claims. The Commission hereby rejects the Company's arguments on this issue. To carry out its statutory duty to determine the most reasonable capital structure for ratemaking purposes, the Commission must consider all the proposals and evidence in the record.

In this regard the Commisison views NWB's claim regarding the legal impact of *Northwestern Bell Telephone Company v. State*, 299 Minn. 1, 216 N.W.2d 841 (1974) as an erroneous reading of that Court's decision. The Commission does not believe that the Supreme Court in *NWB v. State* established as a matter of law that the Commission must first determine that the company-

proposed capital structure is unreasonable before it evaluates or selects an alternative proposal. In that decision the Court conducted its review on the basis of the record before it. That record did not contain competing capital structure proposals. On the basis of that record the court determined that the Commission's decision approving the company's proposed capital structure was supported by evidence contained in the record.

Previous Commission decisions, including *Northwestern Bell Telephone Company,* Docket No. P-421/GR-82-2003 (April 10, 1983) and *United Telephone Company,* Docket No. P-430/GR-82-200 (April 27, 1983) in so far as they may be interpreted to suggest that there must be a finding of unreasonableness of a company's proposed structure before an alternative is entertained, are clarified by this Order. In order for the Commission to determine the most reasonable capital structure for ratemaking purposes, the Commission must have the flexibility to examine all proposals. Requiring the Commission to find a company's proposed capital structure unreasonable before it entertains an alternative capital structure would unnecessarily hamper the Commission's flexible approach to selection of the most reasonable capital structure.

The Commission agrees with the ALJ that NWB failed to demonstrate the reasonableness of its proposed capital structure for ratemaking purposes. NWB ultimately proposed a capital structure containing a 56.4% equity ratio. This equity ratio is considerably higher than the 50.1% equity ratio proposed by NWB witness Bauhard and authorized by the Commisison in *NWB,* P-421/GR-82-203, only five months prior to the filing of the instant case. In *South Central Bell v. Louisiana P.S.C.,* 373 So. 2d 48 (1979), the court concluded as follows:

> [It is not] imcumbent on the commission to find the company's actual capital structure unreasonable before it could set a rate of return on the basis of a hypothetical structure. Such a requirement would be anomalous, since South Central Bell is requesting the rate increase and, therefore, bears the burden of proving that the increase is due, in part, to its capital structure, **the company should also bear the burden of justifying the portion of the increase attributable to its management's choice of capital structure.** (Emphasis added)

NWB has failed to justify the reasonableness of the significant increase in its proposed equity ratio for ratemaking purposes since its last rate case.

NWB argues that, as a result of divestiture, the prior capital structure is no longer appropriate. However, NWB has introduced no evidence to demonstrate a shift in total risk or to quantify that total risk. Its main assertion is that an authorized equity ratio containing only 50.1% equity would cause a reduction in its bond rating. The Commissin finds this argument unconvincing. No reduction in the Company's bond rating was experienced when, as a consequence of the Company's last general rate proceeding, it was authorized a common equity component of 50.1% for regulatory purposes.

There is no evidence in the record, either, that maintenance of the highest possible bond rating alone is a legitimate regulatory goal. The Commission finds that the potentially lower cost of issuing debt afforded by a AAA bond rating will not automatically result in a lower overall cost of capital to a company and its ratepayers.

The Commission notes that NWB's actual capital structure at the time of *NWB*, P-421/GR-82-203 contained 61.1% common equity; use of this actual capital structure was not proposed by the Company or any other party in that proceeding. It is, therefore, illogical for NWB to now argue that failure to use NWB's actual capital structure in this proceeding would be inconsistent with the Commission's findings in *NWB*, P-421/GR-82-203.

The Company also suggests that, somehow, to allow less than a 55% equity ratio would either violate or materially interfere with the decision of the Federal Divestiture Court and the MFJ. Again, the Company attempts to use an Order of the Federal Court which was not entered for regulatory ratemaking purposes to, largely, avoid the issue. In the Company's last general rate proceeding, which concluded after the issuance of the MFJ, the Company supported a 50.1% common equity ratio. The Commission finds this argument by NWB to be without merit.

Based on the above findings and discussion, the Commission concludes that NWB has presented no convincing evidence as to the reasonableness of its capital structure for ratemaking purposes and has thus failed to sustain its burden of proof under Minn. Stat.

§ 237.075, subd. 4 (1983 Supp.). The Commission must now determine an appropriate and reasonable capital structure based upon competent evidence in the record.

The Commission agrees with the ALJ that the capital structure recommended by the RUD-AG, containing 44.6% debt and 55.94% equity, does not differ markedly from that proposed by NWB. The Commission does not find justification in the record for allowing such a significant increase in the equity ratio since *NWB*, P-421/GR-82-203.

The Commission finds, as did the ALJ, that the analysis and recommendation of DPS witness Thompson provides the basis for determining a fair and reasonable capital structure for NWB in this proceeding. Dr. Thompson's analysis provides the Commission with an objective benchmark for judging a reasonable capital structure for regulatory purposes, through his use of proxy companies with similar overall risk to NWB. The Commission used a similar analysis in evaluating the reasonableness of proposed capital structures in *Central Telephone Company*, P-405/GR-83-300 (March 30, 1984).

Dr. Thompson reviewed the five comparable company groups used by the rate of return witnesses in their initial testimonies: Mr. Morris' five telephone companies, Mr. Bauhard's 25 electric companies, Dr. Litzenberger's four electric companies and four telephone companies, and Dr. Amit's four telephone companies. The average common equity raio for these groups was 45.64%. None of these groups had equity ratios as high as the 56.4% proposed by NWB. The Commission finds that Dr. Thompson's analysis indicates that the five groups of companies are reasonably risk comparable to NWB as measured by beta and bond ratings. Therefore, based upon Dr. Thompson's analysis, the Commission concludes that no basis exists for increasing the equity ratio for NWB above the 50.1% level allowed in *NWB*, P-421/GR-82-203. The Commission adopts the ALJ's recommendation to use a 50.1% equity ratio in computing the overall rate of return to be allowed NWB in this proceeding.

The Commission finds it appropriate, as did the ALJ, to consider the 6.3% disallowed portion of equity as imputed debt, at a cost rate of 12.83%. Dr. Thompson derived the 12.83% cost rate based on the average yield of AA-rated utility bonds over the

preceding twelve month period. Using a relatively current cost of debt, rather than the embedded cost of existing NWB debt, is reasonable in this instance and consistent with the Commission's actions in *Northern States Power Company,* Docket No. G-002/GR-78-1052 (September 21, 1979).

Cost of Debt

The Commission observes that a cost of debt range exists on the record beginning with the estimate of 7.80% as of 1/1/84, prior to NWB's transfer of yellow pages and directory advertising services to US West, and ending with 8.5%, the final updated cost of debt which NWB claimed reflects a debt issuance of $150 million in March, 1984. The last cost of debt figure agreed to by all parties was 7.93% as of 1/3/84. The Commission finds it reasonable to reflect the $150 million debt issue since it was known before the close of the record in this proceeding. However, there was dispute over how that issuance affected NWB's embedded cost of debt. The Company did not provide actual numbers to substantiate its claim that the debt issue increased the Company's embedded cost of debt to 8.5%.

Due to the lack of actual Company figures on the embedded cost of debt and the lack of evidence on the record demonstrating the effects of the several transfers of equity and infusions of debt capital made by the Company in the course of this proceeding, the Commission finds that it has no alternative but to estimate NWB's embedded cost of debt. Since no actual numbers were provided by the Company to verify its constantly changing embedded cost of debt, the Commission cannot back-track to accurately relect the effect of the $150 million in new debt.

The Commission will adopt 8.22%, the average of the 7.93% and 8.5% as an appropriate cost of debt for regulatory purposes in this proceeding. The Commission finds the 8.22% to be a reasonable estimate of the embedded cost of debt, which gives weight to the March debt issue while recognizing the uncertainty in the record as to the effect of the debt issue. The Commission also serves notice to the Company that it must provide, in future general rate proceedings before this Commission, the actual data used to calculate its embedded cost of debt. If during the course of such future proceedings, changes occur in the Company's amount of debt, the

effect of such changes on the cost of debt shall also be accurately reflected with actual data.

As discussed more fully in the capital structure section, the Commission will use a 12.83% cost rate for the imputed debt in the capital structure.

Overall Rate of Return

Based on the findings and conclusions above, the Commission authorizes an overall rate of return of 11.63% for NWB, calculated as follows:

Source of Capital	% of Total Capital	Cost	Weighted Cost
Debt	43.60%	8.22%	3.58%
Imputed Debt	6.30%	12.83%	.81%
Common Equity	50.10%	14.46%	7.24%
	100.00%		11.63%

***

ORDER

1. Northwestern Bell Telephone Company is entitled to increased gross annual revenues of $45,603,000 so as to produce total annual revenues of $640,073,000 from Minnesota intrastate operations to eliminate both the gross revenue deficiency determined in this case and in *NWB*, P-421/CI-83-203 et al.

2. Within 20 days of the service date of this Order, the Company shall file with the Commission for its review and approval, and serve upon all parties in this proceeding, revised schedules of rates and charges determined in accordance with the total gross annual revenue requirement authorized in paragraph 1 above and the rate design decisions contained herein including the following:

   a. The Company shall make no adjustment in its rate calculations for estimated curtailment or shift (repression) of its test year customer base.

b. For each local exchange service provided to both business and residential customers, the Company shall calculate the rates to establish a ratio of 3.0 to 1.0 between the rates for business and residential customers in each tier of the metropolitan exchange, and a ratio of 2.5 to 1.0 between the rates for business and residential customers in the outstate exchanges.

c. The Company shall calculate revised metropolitan residential local exchange service rates to maintain the existing dollar amount differences between metropolitan residential tier rates and to set the metropolitan business tier rate differentials at 3 times the corresponding metropolitan residential tier rate differentials.

d. The Company shall increase rates for local measured services by the same percentage that rates for single-party flat-rate business and residential local exchange services are increased.

e. The Company shall retain all metered local exchange services and increase rates for these services by the same percentage that rates for single-party flat-rate business and residential local exchange services are increased.

f. The Company shall retain all multi-party local exchange services and shall increase rates for these services by the same percentage that rates for single-party flat rate business and residential local exchange services are increased.

g. The Company shall set the rates for semi-public coin telephone service at the same level calculated for single-party flat-rate business local exchange service.

h. The Company shall retain the PBX trunk rate designation and shall set the rates for this service at levels equal to 115% of the rates for single-party flat-rate business local exchange service.

i. The Company shall retain the multi-line (key) rate designation for business and residential customers, and shall set rates for these services at levels equal to 105% of the corresponding rates for single-party flat-rate business and residential local exchange services.

j. The Company shall set the revised rates for centrex and group use exchange access lines at the same levels calculated for PBX trunks.

k. The Company shall increase rates for extended area service by the same percentage single-party flat rate business and residential local exchange services are increased.

l. The Company shall increase the surcharges for operator assisted long distance calls by the same percentage that rates for single-party flat-rate residential local exchange services are increased. The Company shall round the revised rates to the nearest 5 cents.

m. The Company shall revise rates for touch-tone service provided in association with each category of local exchange service to reflect the rate changes authorized for those services. The Company shall eliminate the touch-tone charge applied to centrex extenson stations and apply the same touch-tone rate to business 1-party flat rate local service and semi-public coin telephone service. The Company shall provide touch tone service to qualified physically or mentally impaired persons without charge.

n. The Company shall increase rates for custom calling features to the levels it proposed in its initial filing except that the Company shall provide the speed-calling 8 feature to physically or mentally impaired persons without charge.

o. The Company shall eliminate the 53e directory assistance credit and increase rates for calls to directory service from 20 to 25 cents as it proposed in its initial filing. The proposal to increase the rates for directory assistance calls placed through the "0" operator is rejected.

p. The Company shall increase rates for private line services not involved in the Revised Private Line Case as it proposed in its initial filing.

q. The Company shall implement any other uncontested proposals as it proposed in its initial filing.

3. The Company shall provide, with the schedule of rate and charges referred to in paragraph 2 above, supporting documentation which demonstrates that the proposed schedule of rates will generate the level of revenues authorized in paragraph 1 above.

4. Within 20 days of the service date of this Order, the Company shall file with the Commission for its review and approval, and serve upon all parties in this proceeding, a proposed customer notice explaining the final prospective rates.

5. Any party wishing to submit comments regarding the filings from paragraphs 2, 3, and 4 above shall submit such comments to the Commission and all parties in this proceeding, in writing, within 10 days of service by the Company.

6. The Company shall, in all future rate case filings, identify the present and proposed test year revenues, and the present and proposed test year number of customers or revenue producing units, for all major categories of service provided to customers or exchange access provided to other carriers.

7. The Company shall make an annual report regarding the revenues, expenses, and prepaid directory expenses associated with the provision of directory operations as specified in Section VI, subpart X, of the Operating Income Statement portion of this Order. The annual report for each calendar year shall be due by March 31 of the subsequent year. The Company shall provide any missing information for past calendar years within 60 days of the service date of this Order.

8. Pending the Commission's decision in *NWB*, P-421/M-85-816, the Company shall apply rates determined under prior contractual agreements for service provided all conventional radio common carriers as permanent rates, shall apply proposed Feature Group A & E access rates for services provided to NewVector as permanent rates, and shall apply the rates originally proposed in *NWB*, P-421/M-84-189 for services provided to MCI/Cellcom Cellular as interim rates.

9. The Motions for Dismissal filed by the Recipient Families United for Justice, the St. Cloud Area Ratepayers, Even J. Henry, the Minnesota Public Interest Research Group and the Minnesota Senior Federation are hereby denied.

10. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Mary Ellen Hennen
Executive Secretary

(SEAL)
0574F

APPENDIX 10

BEFORE THE
MINNESOTA PUBLIC UTILITIES COMMISSION

Barbara Beerhalter	Chair
Harry Seymour Crump	Commissioner
Cynthia A. Kitlinski	Commissioner
Roger J. O'Keefe	Commissioner
Darrel L. Peterson	Commissioner

Docket No. U-999/CI-86-177
Issue Date: June 4, 1987

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners

ORDER DENYING RECONSIDERATION

Procedural History

On April 9, 1986, the Minnesota Public Utilities Commission (the Commission) issued its Order Initiating Investigation in this docket. In that Order, the Commission directed the Minnesota Department of Public Service (DPS) to conduct an independent investigation to asses whether any improper communications occurred during Commission proceedings addressing issues of significant financial impact to regulated companies or addressing significant policy issues likely to lead to a significant financial impact on regulated companies. The Commission directed that the investigation cover at least the last several months of the Commission terms of former Commissioners Juanita R. Satterlee, Roger L. Hanson, and Leo G. Adams. The Commission could then use this investigation to remedy any improper influence caused by these contacts.

On July 8, 1986, the DPS submitted its "Report of the Depart-

ment of Public Service to the Minnesota Public Utilities Commission" (the DPS Report). The DPS also submitted the depositions and documents that it obtained in the course of its investigation as supporting exhibits to the DPS Report. On August 13, 1986, Northwestern Bell Telephone Company (NWB) filed a response to the DPS Report.

On July 9, 1986, the Residential Utilities Division of the Office of the Attorney General (RUD-AG) filed a petition requesting the Commission to reopen and reconsider its July 27, 1984, Findings of Fact, Conclusions of Law, and Order in *Northwestern Bell Telephone Company*, Docket No. P-421/GR-83-600 (*NWB 83-600*). On July 18, 1986, NWB filed its reponse to the RUD-AG petition. On August 1, 1986, the RUD-AG filed a reply brief to NWB's response. On September 15, 1986, NWB responded to the RUD-AG reply brief.

On August 14, 1986, the Minnesota Public Interest Research Group (MPIRG) filed a petition requesting that the Commission vacate and dismiss its July 27, 1984 and November 13, 1984 Orders in *NWB 83-600*. On September 15, 1986, NWB responded to MPIRG's petition.

On October 3, 1986, the Commission issued its Order Establishing Procedures and Soliciting Briefs in this matter. On October 23, 1986, United Telephone Company (United), the Suburban Rate Authority (SRA), MPIRG, RUD-AG, NWB and the DPS filed comments or briefs. On October 24, 1986, the Minnesota Business Utility Users Council (MBUUC) filed a letter addressing this matter and U.S. Sprint filed a brief. On Novebmer 3, 1986, NWB filed its Reply to the submissions of the other parties.

Oral argument was held on November 6, 1986; representatives of the DPS, the RUD-AG, MPIRG, the SRA, the MBUUC, AT&T, and NWB participated.

On April 2, 1987, the Commission issued its Order After Investigation and Vacating July 27, 1984 Order in Docket No. P-421/GR-83-600 (April 2 Order) in this proceeding. In that Order the Commission voided its July 27, 1984 Order in *Northwestern Bell Telephone Company*, Docket No. P-421/GR-83-600 and reopened that case for further deliberation and the issuance of a new decision and order.

On April 16, 1987, NWB filed a Petition for Reconsideration and

Vacation in this matter. On April 27, 1987, the RUD-AG filed a Memorandum in Opposition to the NWB Petition and the DPS filed its Reply to the NWB Petition. MPIRG filed its Reply to the NWB Petition on May 4, 1987.

On May 27, 1987, the Commission met to consider NWB's petition and the responsive pleadings of the other parties.

FINDINGS AND CONCLUSIONS

The Commisison finds that in its Petition for Reconsideration and Vacation NWB relied on arguments it has previously made in this proceeding and which the Commission exhaustively addressed in its April 2 Order. The Commission reaffirms its earlier findings and conclusions on the seriousness of the abuse NWB inflicted on the regulatory process and also reaffirms the Commission's legal authority to reopen this matter. However, the Commission will clarify its findings in regard to two of NWB's positions on reconsideration.

First, NWB asserts that its due process rights were violated in this proceeding because the Commission did not refer this matter for a contested case hearing.

The Commission reminds NWB that its October 3, 1986 Order Establishing Procedures and Soliciting Briefs in this matter gave all parties an opportunity to comment on and make recommendations on the process the Commission would use. Specifically, that Order requested parties to address five questions in their briefs on whether *NWB 83-600* or any other Commission decisions in the relevant time period were improperly influenced due to a conflict of interest or ex parte communications between former Commissioners Adams, Hanson, or Satterlee and regulated companies. The fifth question to be addressed was: "Is the evidence contained in the DPS Report, depositions and exhibits sufficient for the Commission to resolve the questions posed above? If not, identify specific evidence challenged or to be introduced that a party believes is necessary for the commission to resolve the questions."

In its October 23, 1986 Comments in response to the Commission's October 3, 1986 Order, NWB simply stated that it would object to reopening any of the dockets in question based on the depositions and exhibits provided by the DPS. NWB further stated

that since no violation of statutes or rules occurred even under that evidence and since the Commission had no authority to reopen the dockets, "there is no need for additional proceedings to resolve these evidentiary problems." However, NWB did not in any of its comments or responsive pleadings following the October 3, 1986 Order offer additional evidence nor did it request a process to develop further evidence.

Furthermore, it is axiomatic that the purpose of a contested case hearing is to resolve disputed material facts. The Commission finds that there is no dispute regarding the material facts that led to the reopening of *NWB 83-600* and concludes that a contested case hearing was not necessary in this proceeding. Throughout this matter, the Commission has recognized, addressed, and protected NWB's due process rights.

Second, in an extension of its argument on the Commission's authority to reopen *NWB 83-600*, NWB asserted that the Commission is bound by the Minnesota Supreme Court decision in *Henry v. Public Utilities Commission*, 392 N.W.2d 209 (Minn. 1986). That decision held that the rates established in *NWB 83-600* are just and reasonable. NWB argued that the *Henry* decision requires the Commission to vacate its April 2 Order in this proceeding. The Commission disagrees. The issue of abuse of the Commission's process which is the legal basis for redeliberating *NWB 83-600* was not before the Court in *Henry*. That decision did not address the abuses of the regulatory process that the Commission has determined undermined the integrity of the decisionmaking process in *NWB 83-600*. Therefore, the Commission concludes that the *Henry* decision is no longer relevant and that the Commission has correctly reopened *NWB 83-600* for redeliberation.

The Commission finds NWB has not raised any issues or matters that the Commission has not previously considered. The Commission concludes that there is no basis to alter its April 2, 1987 Order After Investigation and Vacating July 27, 1984 Order in Docket No. P-421/GR-83-600 in this proceeding. Therefore, the Commission will deny NWB's Petition for Reconsideration and Vacation.

ORDER

1. Northwestern Bell Telephone Company's Petition for Reconsideration and Vacation is hereby denied.
2. This Order shall become effective immedicately.

BY ORDER OF THE COMMISSION

Mary Ellen Hennen
Executive Secretary

(SEAL)

MEH:sj
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APPENDIX 11

STATE OF MINNESOTA
IN COURT OF APPEALS
#C7-87-1296
#C9-87-1297

Minnesota Public Utilities Commission

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners. (C7-87-1296)

In the Matter of the Petition of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota. (C9-87-1297)

OPINION

SEDGWICK, Judge.

In separate appeals to this court, relator Northwestern Bell has requested review of two orders by the Public Utilities Commission which vacated and modifed a prior 1984 rate order. We consolidated the two appeals. We affirm in part and reverse in part.

FACTS

This case has a complex and lengthy procedural history. On September 29, 1983, Northwestern Bell filed a petition with the Minnesota Public Utilities Commission ("Commission"), seeking a $109 million annual rate increase. Between January and April 1984, hearings on the petition were conducted by an administrative law judge ("ALJ"). The proceedings concerning this petition are referred to as "Docket 600."

On May 16, 1984, intervenors Minnesota Public Interest Research Group ("MPIRG"), Evan Henry, and the Department of Public Service ("DPS") petitioned the ALJ for dismissal of Northwestern Bell's pending rate case, because Northwestern Bell had filed a res-

tructuring plan with the Federal Communications Commission in January 1984 which was presented to the Minnesota Commission in April. The Commission ordered the DPS to investigate the fincnacial effect of Northwestern Bell's restructuring on the pending rate action. Northwestern Bell and the DPS subsequently stipulated that the effect of the reorganization should be considered within the context of the rate proceeding, and the DPS withdrew its motion to dismiss.

Before the DPS investigation was completed, however, the ALJ recommended to the Commission that the rate petition be dismissed, because it appeared tht the financial effect of Northwestern Bell's reorganization would be substantial. On June 8, 1984, the Commission voted 2 to 1 not to dismiss the rate petition, but to consider the effect of Northwestern Bell's corporate restructuring in the context of the rate proceeding. Commissioners Leo Adams and Roger Hanson voted not to dismiss. Prior to the Commission's vote, Commissioner Hanson wrote and distributed a memorandum recommending denial of the motion to dismiss.

Following the completion of the contested case proceeding, the ALJ recommended that the Commission award Northwestern Bell a $36.1 million rate increase. On July 27, 1984, the Commission granted Northwestern Bell a rate increase of $57,511,000.

In August and September 1984, the Commission heard petitions for rehearing and modification. The DPS recommended reduction of the rate increase by $363,000. The Commission, on its own motion, ordered a rehearing and reopening of the record, and on September 26, 1984, the Commission adopted the DPS recommendation, and modifed the rate increase from $57,511,000 to $57,148,000.

Intervenor Henry appealed the Commission's decision, claiming that the Commission's final decision was untimely, because it was not rendered within ten months from the date of Northwestern Bell's petition for a rate increase; that the Commission should have conducted a second contested case hearing before it modified the original order; and that Northwestern Bell had not met its burden of proving the new rates were just and reasonable.

The case was appealed to the Minnesota Supreme Court, which concluded that the Commission had acted within its statutory authority in ordering a rehearing; that the Commission was not required

to hold a contested case hearing before it modified its decision; that the summary procedure adopted by the Commission for rehearing did not deprive Henry of due process; and that the decision of the Commission regarding Northwestern Bell's rates was supported by the record and was not arbitrary and capricious. *Henry v. Minnesota Public Utilities Commission,* 392 N.W.2d 209 (Minn. 1986).

On April 9, 1986, prior to the supreme court's decision in *Henry*, the Commission ordered an investiagtion of the proceedings which led to its decision in Docket 600. This investigation, referred to as Docket 177, concerned reports alleging that numerous ex parte contacts had occurred between former Commissioners Adams and Hanson, and a representative of Northwestern Bell, Roy Weir, during the pendency of Docket 600 and other cases. On July 8, 1986, the DPS issued a report which concluded, in part, that during the months Docket 600 was pending before the Commission, Weir had met on numerous occasions with Commissioners Adams and Hanson in restaurants; that Northwestern Bell had paid for those meals; that Weir and the two Commissioners all testified in depositions that those meetings had not involved discussions of Docket 600 issues; that during the time Docket 600 was pending before the Commission there was no statute or rule in Minnesota which prohibited ex parte contacts between Northwestern Bell and the Commission or which prohibited Northwestern Bell from paying for meals consumed by Commissioners; and that it was unlikely that Commissioners could be bribed with free meals. The DPS report did not recommend reopening or reconsidering Docket 600.

On July 9, the Attonery General petitioned to reopen and consider Docket 600, and on August 14, 1986, MPIRG petitioned to vacate and dismiss Docket 600, based upon the ex parte communications between Weir and the two Commissioners. Subsequently, on October 3, 1986, the Commission issued an order inviting briefs and comment from all of the parties involved. On October 22, 1986, the DPS issued a second report, recommending that the Commission redeliberate its decision in the 1984 rate order.

On November 7, 1986, the Commission began deliberating whether it should take any new action regarding the 1984 rate order. The Commission thereafter voted to approve the Attorney General's petition to reconsider the 1984 rate order.

Between February 12 and 19, 1987, the Commission reconsidered

the issues involved in Docket 600, and on April 2, 1987, the Commission issued a final order vacating the 1984 rate order and reopening that order for further deliberation and issuance of a new decision and order. Two days later the Commission issued its new decision, modifying certain terms and reducing Northwestern Bell's rates from $57,148,000 to $45,603,000. This final decision was rendered without conducting a new contested case hearing.

The Commission made the following changes to the 1984 order:

(1) The Commission used a hypothetical capital structure to set Northwestern Bell's rates;

(2) The Commission imputed hypothetical directory revenues to Northwestern Bell as the result of a transfer of Northwestern Bell's directory publication to an independent company;

(3) The Commission continued the requirement that Northwestern Bell reduce its rates due to a tax surplus; and

(4) The Commission required that Northwestern Bell provide Touch-Tone and Speed Call 8 services free to eligible handicapped customers.

In two separate appeals to this court, Northwestern Bell has challenged the Commission's actions. In appeal No. C7-87-1296, Northwestern Bell challenged the commission's determination that Weir engaged in improper contacts with Commissioners Adams and Hanson, which affected the Commission's original 1984 rate order. Northwestern Bell also claims that the Commission had no authority to reopen the 1984 order; that the supreme court decision in *Henry* bars this action under the doctrine of res judicata; that the Commission's order to reopen violates the 10-month rule of Minn. Stat. § 237.05; and that the Commission's prodedures violated Northwestern Bell's constitutional and statutory rights.

In appeal No. C9-87-1297, Northwestern Bell has challenged the changes which the Commission actually made to the 1984 rate order.

ISSUES

1. Did the Commission have the authority in 1987 to conduct an investigation of its 1984 rate order?
2. Did the Commission's actions violate the 10-month rule of Minn. Stat. § 237.075 (1986)?
3. Did the Commission have the authority to vacate its 1984 rate order based upon "fraud on the tribunal"?
4. Did the Commission deny Northwestern Bell certain procedural rights?
5. Did the Commission err by failing to consider issues raised in Northwestern Bell's motion for reconsideration?
6. Did the Commission err by establishing prospective rated based upon 1983 test year financial data?
7. Did the Commission err by employing a hypothetical capital structure when modifying Northwestern Bell's rate?
8. Did the Commission improperly impute hypothetical directory revenues to Northwestern Bell?
9. Did the Commission erroneously require Northwestern Bell to reduce its customers' rates due to a tax surplus which had already been depleted?
10. Did the Commission err by requiring Northwestern Bell to provide certain services to handicapped customers free of charge?

ANALYSIS

1. Investigation and Hearing.

Northwestern Bell objects to the summary investigation by the DPS and the evidence obtained therefrom, complaining that it was required to respond to discovery requests even though the DPS refused itself to respond to any requests for information. Northwestern Bell also claims that the Commission should have ordered a contested case hearing, since the reasonableness of its rates was at issue.

We find Northwestern Bell's complaints to be without merit. In so doing, we rely upon the following language in *Henry*:

> Minn. Stat. § 237.081, subd. 1 (1984) provides the MPUC may, on its own motion, summarily investigate any matter relating to any service it believes "for any reason" should be examined. If, after making such

> summary investigation, the MPUC is satisfied there are sufficient grounds to warrant a formal hearing on the matters investigated, it may initiate such a hearing. Minn. Stat. § 237.081, subd. 2 (1984).

Henry, 392 N.W.2d at 212 n.1.

Henry also explained that a contested case hearing is required only if the Commission has determined that "significant issues" cannot be resolved to the satisfaction of the Commission. *Id.* at 214. Since the Commission did not order a contested case hearing, it must have concluded that the reasonableness of the rates was not a significant issue which could not be resolved to the satisfaction of the Commission.

We also note that although Northwestern Bell objected to the summary investigation, at the time it did not specifically request a contested case hearing, but instead argued that there was no need for the Commission to take any action whatsoever regarding the 1984 order.

2. Ten-Month Rule.

Northwestern Bell claims the Commission's order reopening the 1984 rate order violated the 10-month rule of Minn. Stat. § 237.075, subd. 2 (1986), which provides in part:

> If the commission does not make a final determintaion concerning a schedule of rates within ten months after the initial filing date [of the original petiton for an increase in rates], the schedule shall be deemed to have been approved by the commission ***. For the purpose of this section, "final determination" means the initial decision of the commission and not any order which may be entered by the commission in response to a petition for rehearing or other relief.

Under similar circumstances, the supreme court in *Henry* rejected Northwestern Bell's claim that the Commission's reopening of a portion of its 1984 order constituted an improper effort to circumvent the 10-month statutory limitation. The *Henry* court explained:

> The statutory time limit refers only to the period during

> which rates may be suspended and is not a temporal limit on the MPUC's jurisdiction ***. The clear purpose of the provision is to protect utilities from the potentially confiscatory effect of regulatory delay. In other cases where we have interpreted similar statutory time limits, we have construed these provisions as directory and not mandatory, stating the time limit *** '[is] obviously designed merely to secure order, uniformity, system, and dispatch in the public business." *** Consistent with these cases, we conclude subdivision 2 does not deprive the MPUC of jurisdiction to issue a decision in a rate proceeding if it fails to reach a decision within the 10-month suspension period.

392 N.W.2d at 213-14 (citation omitted). In view of the above language, we reject Northwestern Bell's argument that the 10-month rule barred the Commission's reopening and modification of the 1984 order.

3. Fraud on the Commission.

Northwestern Bell points out that the ex parte contacts between Weir and Commissioners Hanson and Adams were not actually prohibited by statute in 1984. In fact, Northwestern Bell argues that certain rules and statutes in existence at the time suggested that such lobbying of the commission was to be expected.

Minn Stat. § 216A.02 (1984) defines the Commission's three functions: legislative, administrative and quasi-judicial. Certainly, in matters of the Commission's legislative and administrative functions, some discussion with representatives of the utilities which it regulates is to be expected. However, in matters concerning the Commission's quasi-judicial function, such contacts cannot be condoned.

The Commission did not address the question whether Northwestern Bell's ex parte contacts with the Commission members were illegal; rather, the Commission looked at whether those ex parte contacts constituted an abuse of process, or a type of fraud upon the Commission.

In Minnesota, a court may vacate a judgment within a specific period of time due to extrinsic or intrinsic fraud. Minn. R. Civ. P. 60.02. Rule 60 also recognizes and distingushes the type of case where "fraud upon the court" is alleged. In discussing this doctrine,

one commentator has stated:

> Fraud upon the court differs from extrinsic or intrinsic fraud. *** Some federal courts have attempted to define fraud upon the court as conduct which defiles the court itself or in which court officers conduct themselves in a way as to impair judicial machinery and prevent an impartial adjudication. *** Other courts have defined this type of fraud as an unconscionable plan or scheme to improperly influence the court in its decision. ***
>
> *** The concept clearly includes bribery of a judge or the employment of counsel in order to bring an improper influence on the court.

2A D. Herr & R. Haydock, *Minnesota Practice* § 6024 (1985) (citations omitted).

In *Halloran v. Blue and White Liberty Cab Co.*, 253 Minn. 436, 92 N.W.2d 794 (1958), the Minnesota Supreme Court stated:

> A judgment may be set aside at any time for after discovered fraud upon the court. Where a court is misled as to material circumstances, or its process is abused, resulting in the rendition of a judgment which would not have been given if the whole conduct of the case had been fair, the court has inherent power to vacate for fraud and that power includes as well the power to modify.

Id. at 442, 92 N.W.2d at 798.

In *Hazel-Atlas Glass Co. v. Hartford-Empire Co.*, 322 U.S. 238 (1944), the Supreme Court recognized the abhorrence with which "fraud upon the court" is viewed. the *Hazel-Atlas* court stated:

> [T]ampering with the administration of justice in the manner indisputably shown here involves far more than an injury to a single litigant. It is a wrong against the institutions set up to protect and safeguard the public,

> institutions in which fraud cannot complacently be tolerated consistently with the good order of society.

Id. at 246.[1]

We recognize that Rule 60.02 and the *Halloran* decision govern fraud on the "court," and do not address the question whether a similar doctrine should be held to exist within the administrative process. Northwestern Bell argues that the Commission has no similar authority to reopen orders based on "fraud on the Commission," since the legislature has not expressly given the Commission such authority.

In *WKAT, Inc. v. Federal Communications Commission*, 296 F.2d 375 (D.C. Cir. 1961), the Federal Communications Commission had awarded an application for a permit to construct a television station. While an appeal to the court was pending, information came to light which indicated that WKAT had improperly sought to influence the results of the application. The court remanded the case for an evidentiary hearing on the misconduct, and the Commission appointed a master, conducted hearings, and issued an order disqualifying the applicants. The court subsequently held the order proposed by the Commission to be within its authority.

While the Commission in *WKAT* was proceeding according to the directives of the court, the *WKAT* opinion suggests that administrative agencies should have the same inherent power to reopen their judgments that is accorded the courts under the doctrine of fraud upon the court:

> This doctrine applies to the adjudicatory functions of an administrative agency. This is not a mere techicality. Surreptitious efforts to influence an official charged with the duty of deciding contested issues upon an open record in a court with basic principles of our jurisprudence, eat the very heart of our system of government—

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[1]Northwestern Bell takes the position that the Commission erroneously based its decision to reopen the 1984 rate order on its unsupported belief that the public distrusted the process. Whether or not the public actually distrusted the process, the *Hazel-Atlas* decision recognizes that the process is designed for the benefit of the public, and should not be abused.

> due process, fair play, open proceedings, unbiased, uninfluenced decision. He who engages in such efforts in a contest before an administrative agency is fortunate if he loses no more than the matter involved in that proceeding.

Id. at 383.

In Minnesota, two recent appellate decisions have discussed the question whether an agency has powers which have not been specifically delegated by statute. In *Senior Citizens Coalition v. Minnesota Public Utilities Commission*, 355 N.W.2d 295 (Minn. 1984), the supreme court stated:

> The PUB is a state agency of statutory origin. *** As such, it has only that jurisdiction conferred to it by the legislature. *** "A lack of statutory authority betokens a lack of jurisdiction."

Id. at 302 (quoting *State ex rel. Spurck v. Civil Service Board*, 226 Minn. 253, 259, 32 N.W.2d 583, 586 (1948)).

In *Peoples Natural Gas Co. v. Minnesota Public Utilities Commission*, 369 N.W.2d 530 (Minn. 1985), the court again indicated that a lack of express statutory authority required reversal of a Commission decision. There, again, the court hled that the Commission does not have implied authority:

> Neither agencies nor courts may under the guise of statutory interpretation enlarge the agency's powers beyond that which was contemplted by the legislative body.

Id. at 534 (quoting *Waller v. Powers Department Store*, 343 N.W.2d 655, 657 (Minn. 1984)).

We find the *Senior Citizens* and *Peoples* cases distinguishable, since in those cases the Commission had attempted to exercise an implied authority to award costs or refund revenues, whereas here, the Commission was simply attempting to correct a previous order. We also rely upon a line of Minnesota cases which suggests that the Commission had the implied authority to reopen its 1984 decision.

In 1958, the Minnesota Supreme Court recognized that administrative agencies have powers similar to those exercised by the courts under Rule 60. In *Anchor Casualty Co. v. Bongard Co-operative Creamery Association*, 253 Minn. 101, 91 N.W.2d 122 (1958), the court stated:

> While it is true that the statute in question, § 27.06, does not specifically grant to the commissioner the power to open and rehear matters, neither does it deny that power to him. ***
> *** It is generally recognized that one of the powers proper to an efficient and just administration of the right to adjudicate is the power to reverse and adjudication which appears to be erroneous. (Federal Rules of Civil Procedure, Rule 60[b].) This power lasts until jurisdiction is lost by appeal or certiorari or until a reasonable time has run ***.

Id. at 105-06, 91 N.W.2d at 125-26. Citing *Handlon v. Town of Belleville*, 4 N.J. 99, 106, 71 A.2d 624, 627 (1950), the court stated:

> Barring statutory regulation, the power may be invoked by administrative agencies to serve the ends of essential justice and the policy of law. But there must be reasonable diligence. The denial to such tribunals of the authority to correct error and injustice and to revise its judgments for good and sufficient cause would run counter to the public interest. The function cannot be denied except by legislative fiat; and there is none such here. The power of correction and revision, the better to serve the statutory policy, is of the very nature of such governmental agencies.

Id. at 106, 91 N.W.2d at 126. In *State ex rel Turnbladh v. District Court*, 259 Minn. 228, 107 N.W.2d 307 (1960), also, the court stated:

> [A]n administrative agency has a well-established right to reopen, rehear, and redetermine the matter even after a

determination has been made. This is a rule of general application.

Id. at 236, 107 N.W.2d at 312. The *Turnbladh* and *Anchor Casualty* cases have been recently cited with approval. *See, e.g., Stearns-Hotzfield v. Farmes Insurance Exchange*, 360 N.W.2d 384, 389 (Minn. Ct. App. 1985).

This line of cases recognizes that an administrative agency has the inherent power to correct its prior decisions. In the past, these decisions have been limited to the "normal" Rule 60 situation, where the power of the tribunal is limited by time constraints. However, since administrative agencies hve been accorded a Rule 60 type of authority to reopen and consider decisions based upon allegations of extrinsic or intrinsic fraud, we the Commission must also possess the implied authority to reopen judgments at anytime based on the "fraud on the court" doctrine recognized by Rule 60.02.

The Commission determined that the number and timing of the ex parte contacts between Northwestern Bell and Commissioners Hanson and Adams sustained the inference that Northwestern Bell's actions were intended to influence tht Commission's decision in Docket 600. The record supports the Commission's determination. During the time the Commission was deliberating on Northwestern Bell's petition for a rate increase, numerous meetings were held between Weir and Commissioner Adams and Hanson. Those meetings were all paid for by Northwestern Bell. The dates upon which Weir paid for meals for Commissioners Hanson and Adams occurred during the time Docket 600 was pending before the Commission. The evidence is more than sufficient to sustain the Commission's inference that Northwestern Bell's actions were intended to influence the commission, and therefore constituted a fraud on the commission. *See Gibson v. Civil Service Board*, 285 Minn. 123, 171 § 712 (1969) (an agency's reasonable inferences from the facts should be sustained if there is substantial evidence in the record tending to support those inferences).

Nevertheless, Northwestern Bell argues that there has been no proof that the improper ex parte contacts actually affected the

Commission's final rate decision.[2] We disagree.

As the supreme court recently stated in a similar situation:

> While the record contains no direct evidence that Adams unduly influenced the decision, his mere presence creates the obvious appearance of impropriety and undermines the public confidence in the system. We are incredulous that these sophisticated governmental and utility officials could have assumed otherwise. We therefore hold that there is substantial evidentiary support for the findings of the Commission that the individuals had a duty to disclose their association, that Adams has a substantial conflict of interest and that the proceedings were tainted as a result.

In re Northern States Power Co., ___ N.W.2d ___, slip op. at 7 (Minn. Oct. 23, 1987).

Here, after hearing the testimony of the parties, the ALJ, who was uninfluenced by the ex parte communications, recommended the adoption of a $36.1 million rate increase. The Commission, however, voted to grant Northwestern Bell a rate increase in the

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[2]In *PATCO v. Federal Labor Relations Authority*, 685 F.2d 547, 564 (D.C. Cir. 1982), the court noted that improper ex parte communications do not render agency proceedings automatically void, but voidable. The *PATCO* court set forth the following standards for determining whether an agency's decision should be vacated:

> [A] court must consider whether, as a result of improper ex parte communications, the agency's decision making process was irrevocably tainted so as to make the ultimate judgment of the agency unfair, either to an innocent party or to the public interest that the agency was obliged to protect. In making this determination, a number of considerations may be relevant: the gravity of the ex parte communications; **whether the contacts may have influenced the agency's ultimate decision; whether the party making the improper contact benefited from the agency's ultimate decision;** whether the contents of the communications were unknown to opposing parties, who therefore had no opportunity to respond; and whether vacation of the agency's decision and remand for new proceedings would serve a useful purpose.

Id. at 564-65 (footnotes omitted (emphasis added).

amount of $57,511,000. This discrepancy provides further support for the Commission's subsequent determination that the proceedings in Docket 600 were tainted by the ex parte contacts.

4. Denial of Oral Argument.

The Commission based its 1987 order upon the record compiled during the 1984 contested case proceedings. In modifying the 1984 decision in April 1987, the Commission did not afford Northwestern Bell an opportunity to present oral argument on the merits. The Commission also issued its order denying reconsideration of the April 1987 decision without allowing Northwestern Bell an opportunity to present oral argument. Northwestern Bell claims the denial of oral argument before the new Commissioners in 1987 constituted a deprivation of its constitutional and statutory rights.

Minn. Stat. § 14.61 (1986), cited by Northwestern Bell, is entitled "Agency Decision in Contested Case," and provides:

> In all contested cases the decision of the officials fo the agency who are to render the final decision shall not be made until *** an opportunity has been afforded to each party adversely affected to file exeptions and present argument to a majority of the officials who are to render the decision.

This statute clearly refers to a final decision after a contested case hearing, and therefore would have required oral argument in 1984. Northwestern Bell does not claim it was denied oral argument in 1984.

In 1987, when the Commission reopened the 1984 order and issued a new decision on the merits, there was no statute requiring that the parties be allowed to present a second oral argument. Indeed, there was no statute which provided for the procedures used by the Commission in reopening and reconsidering the 1984 order; thus, we believe basic notions of fairness in the decison-making process should control.

The equities weigh against oral argument in the present situation. Northwestern Bell argues that basic concepts of fair play require the allowance of a new opportunity to present oral argument; however, because the ex parte contacts between Northwestern Bell and the Commission in fact constituted fraud on the Commission,

Northwestern Bell, itself, cannot be deemed to have engaged in fair play from the beginning. The maxim "He who seeks equity must do equity" is applicable here.

5. Order on Reconsideration.

Northwestern Bell claims that, upon reconsideration of its April 1987 order, the Commission failed to address several issues. In its order denying reconsideration, the Commission stated:

> The Commission finds that the parties have raised no new arguments or evidence in Petitions for Reconsideration that have not already been thoroughly considered by the Commission.

Northwestern Bell claims that several new arguments were raised in its petition for reconsideration, and the Commission therefore erred by determining that these new arguments had been previously considered. We find this claim to be without merit.

6. Financial Data.

Northwestern Bell also argues that the Commission improperly used 1983 test year data in making its 1987 modifications to the 1984 rate order. This argument fails to take into consideration the fact that the 1987 order was simply a modification of the prior 1984 order, and not a consideration of a new request by Northwestern Bell for prospective rate increases. The Commission clearly had no authority to use 1987 data, since a new contested proceeding had not been conducted. Use of the 1983 test year data was therefore proper.

7. Hypothetical Capital Structure.

Northwestern Bell argues that the Commission had no authority to reevaluate its capital structure, since in *Henry*, the Minnesota Supreme Court had already affirmed the reasonableness of the capital structure established in the 1984 rate order.

While *Henry* determined that the rates set by the Commission in its 1984 order were reasonable, where fraud upon the court is alleged, the principal of res judicata may not be invoked. *See Halloran*, 253 Minn. at 442, 92 N.W.2d at 798.

Northwestern Bell also argues that the Commission erroneously imposed upon it the burden of proving its capital structure reasonable. Our supreme court recently rejected this argument in *In re*

Northern States Power Co., ___ N.W.2d ___ (Minn. Dec. 11, 1987):

> [E]nactment of Minn. Stat. § 216B.16, subd. 4 (1986) *** placed on the petitioning utility the burden of proving the proposed rate is fair and reasonable, and, as a component of the rate base, that the capital structure debt-equity allocation is fair and just. When, in the Commission's judgment, a petitioning utility has failed to establish the reasonableness of costs which it claims justifies a proposed rate increase, the Commission itself may compute a hypothetical capital structure that will afford an ultimate determination of a reasoanble and just rate.

Id., slip op. at 11 (citation omitted). The Commission therefore correctly assigned to Northwestern Bell the burden of proving its capital structure reasonable.

The *Northern States Power* court also explained the scope of this court's review when the Commission has adopted a hypothetical capital structure:

> [Whether] the Commissioner has adequately articulated its reasoning employed to reach its conclusion that [a utility] had failed to estalish the proposed rate as being "just and reasonable", and [whether] the Commission's conclusion itself was reasonable.

Id., slip op. at 12-13.

Here, the commission articulated the following reason for its determination in 1987 that Northwestern Bell's proposed equity ratio was not just and reasonable:

> NWB ultimately proposed a capital structure containing a 56.4% equity ratio. This equity ratio is considerably higher than the 50.1% equity ratio proposed by NWB witness Bauhard and authorized by the Commission in [another rate case], only five months prior to the filing of the instant case.
>
> ***
>
> NWB argues, that, as a result of divestiture, the prior

> capital structure is no longer appropriate. However, NWB has introduced no evidence to demonstrate a shift in total risk or to quantify that total risk. Its main assertion is that an authorized equity ratio containing only 50.1% equity would cause a reduction in its bond rating. The Commission finds this argument unconvincing. No reduction in the Company's bond rating was experienced when, as a consequence of the Company's last general rate proceeding, it was authorized a common equity component of 50.1% for regulatory purposes.

The record supports the Commission's rejection of Northwestern Bell's proposed equity ratio.

There is substantial evidence in the record supporting the Commission's adoption of a 50.1 percent hypothetical equity ratio. First, the capital structure used by the Commission in Northwestern Bell's prior 1982 rate case included a 50.1% equity ratio. Further, DPS witness Dr. Luther Thompson recommended a capital structure of 50% equity, 43.6% debt and 6.4% imputed debt. This recommendation was based on the average equity ratios of four telephone companies analyzed by one witness, five telephone compaines analyzed by a witness for the Attorney General, 25 electric companies analyzed by a witness for Northwestern Bell, and four telephone companies and four electric companies analyzed by another witness. Dr. Thompson had selected these groups because their average bond ratios and average betas[3] were similar to those of Northwestern Bell. The 50.1 equity component adopted by the Commission approximates the mean equity ratio calculated by Dr. Thompson for the five comparable groups. We therefore conclude the Commission's adoption of a 50.1 percent hypothetical equity ratio was reasonable.

8. Directory Revenues.

In December 1983, shortly before the hearings began on Northwestern Bell's 1983 petition for a rate increase, Northwestern Bell decided to transfer its directory publication operations to U.S. West Direct. In making this transition, Northwestern Bell transferred certain assets to Landmark Publishing, U.S. West Direct's parent com-

[3]A beta is a measure of the volatility of the rate of return of a stock, relative to the stock market as a whole. Relatively less movement of a stock in the market renders that stock less risky, and vice-versa.

pany, and entered into a series of contracts with U.S. West Direct. When the Commission learned of the transfer, it directed the ALJ to consider this transfer in making its recommendations regarding Northwestern Bell's rates.

In Northwestern Bell's initial direct testimony, filed September 1983 with its petition for a rate increase, Northwestern Bell did not adjust its test year financial date to reflect the directory transfer; rather, Northwestern Bell included income, expenses, and investments from directory operations, as in the past, in the calculation of its 1983 test year revenue requirements. Northwestern Bell urged that no modification to its test year financials was justified, since its approach would insulate ratepayers from any possible detrimental effects of the transfer.

Upon learning of the transfer, the Commission requested the parties to discuss in the evidentiary hearings and any future filings the question whether the sale of the directory operations to U.S. West Direct, and the consequent replacement of Northwestern Bell's directory income with fees paid by U.S. West Direct, would have an effect on Northwestern Bell's ratepayers.

The intervenors proposed that the Commission either void Northwestern Bell's transfer of its directory operations and require Northwestern Bell to resume publication, or make an upward adjustment in Northwestern Bell's operating income to account for the growth which would have occurred if Northwestern Bell had continued to publish its directories. The DPS proposed that the Commission take the average of the past three years' growth levels in Northwestern Bell's net directory income, and add that amount to Northwestern Bell's test year operating income.

The ALJ recommended that the Commission adopt the DPS's imputed growth levels, and impute $2,526,666 in directory revenues to Northwestern Bell.

In its 1984 order, the Commission adopted the intervenors' first proposal, voided the transfer, and directed the return of directory operations to Northwestern Bell. On appeal, this court reversed, concluding that the Commission lacked such authority. *See In re Northwestern Bell Telephone Co.*, 367 N.W.2d 655 (Minn. Ct. App. 1985).

In its 1987 order after reconsideration, the Commission adopted the intervenors' alternative proposal and the ALJ's recommendation

that $2,526,666 be imputed to Northwestern Bell to account for expected revenues from its directory publication.

On appeal, Northwestern Bell argues that the Commission should not have adopted this imputed income, by reason of the following language in this court's opinion in *Northwestern Bell*:

> [T]he Commission is ordered to reinstate the contract between Northwestern and West Direct. The Commission can make a review of the transfer and its future impact on Northwestern's rates on a more complete record **in the next rate case**. If appropriate, an adjustment can be made at that time.

Id. at 663 (emphasis added). Northwestern Bell argues that this language precludes the Commission from imputing directory income in the present case, which is not the equivalent of a "next rate case."

We note, however, the following language in *Northwestern Bell*:

> The Commission can investigate the reasonableness of the publishing fees paid by West Direct to Northwestern pursuant to its inherent power to include the expenses, revenues and investment related to directory advertising in telephone ratemaking proceedings. The Commission's authority is limited to either accepting or rejecting the ALJ's recommendation of imputing income to Northwestern.

Id. at 661.

The Commission was free to review the record and revise it in a reasonable manner. Since this court held that the Commission had no authority to void the directory transfer, the only option for the Commission when it vacated the 1984 order was either to accept or reject the ALJ's recommendtaion of imputing income to Northwestern Bell.

The Commission in its 1987 order accepted the findings of the ALJ that Northwestern Bell's revenues should be increased by $2,527,000 as a result of imputed income from the directory revenues, reasoning that "[t]he benefits appears to lay heavily on

the side of U.S. West's shareholders without a corresponding benefit falling to Minnesota ratepayers." The Commission also adopted the ALJ's reasoning that Northwestern Bell failed to provide the Commission with appropriate date regarding the potential revenue impact of the directory transfer and that substantial evidence supported imputation of income.

The record supports the Commission's imputation of $2,526,666 in income. That number was obtained by using figures provided by Northwestern Bell, even though Northwestern Bell challenged the accuracy of its figures. The ALJ noted that deficiencies in the record caused by a lack of information provided by Northwestern Bell should not require imputation of a lesser amount. Northwestern Bell had the burden of proving its rate increase was reasonable, *See* Minn. Stat. § 237.075, subd, 4. We believe the ALJ did the best he could, based upon the data which Northwestern Bell did provide. The Commission's acceptance of the ALJ's findings and recommendations was not arbitraty and capricious, and those findings and recommendations are supported by the record.

9. Tax Surplus.

In 1983, in a prior rate decision, the Commission adjusted Northwestern Bell's test year figures to amortize, over a three year period, a deferred tax reserve surplus that had resulted from a reduction in federal tax rates.

In its 1984 rate order, the Commission continued to amortize the excess deferred taxes over the three year period.

> The Commission concludes that the surplus tax reserve should continue to be amortized over a three year period as ordered in [the previous 1983 decision].

We must assume that by 1987, the entire tax surplus had been returned to the ratepayers in the form of reduced rates.

In its 1987 order, the Commission ordered Northwestern Bell to return prospectively to it ratepayers the difference between the $57,148,000 rate increase allowed in 1984 and the $45,000,000 rate increase authorized by the 1987 modified order. In that order, however, the Commission did not take into account the fact that Northwestern Bell, after 1985, would have been allowed to charge higher rates, because the three year amortization period of the excess tax reserve surplus would have expired. The Commission

erred by failing to take this fact into account.

10. Touch-Tone and Speed Call 8 Services.

Northwestern Bell provides two servies that were the subject of this 1984 rate design: Touch-Tone and Speed Call 8. The Touch-Tone service enables a telephone user to dial a number by pushing number buttons on the telephone, rather than using a rotary dial. The Speed Call 8 service enables a user to dial preprogrammed two-digit codes, rather than dialing a complete telephone number.

In its 1984 rate order, the Commission set Speed Call 8 and Touch-Tone rates for handicapped persons at $1, in order to facilitate use of the telephone system by those persons. In its 1987 modification of the 1984 order, the Commission ordered Northwestern Bell to provide the Touch-Tone and Speed Call 8 services to handicapped persons without charge.

By requiring handicapped customers to pay for basic local services, but giving them the Touch Tone and Speed Call 8 services free, the Commission attempted to equalize the value of service available to the handicapped customer with that available to non-handicapped customers. In other words, because certain disabilities make the use of a regular telephone difficult, many handicapped customers derive less value from standard telephone service than do other customers.

The Commission's decision regarding this issue involves rate design, which requires the Commission to exercise its legislative decision-making authority. Such authority involves policy decisions, and this court's review is limited to upholding the Commission's action unless it has resulted in unjust, unreasonable or discriminatory rates, or has produced an arbitrary result. *See Hibbing Taconite Co. v. Minnesota Public Utilities Commission*, 302 N.W.2d 5, 9 (Minn. 1980).

While we applaud the reasoning behind the Commission's exercise of its authority in this instance, nevertheless there is no evidence in the record supporting the Commission's decision. While Northwestern Bell has the burden of proving by clear and convincing evidence that the Commission's determination was erroneous, it was unable to meet this burden because, at the time the Commission's decision was rendered in 1984, Northwestern Bell was not aware that the Commission was considering the provison of free services to the handicapped; thus, no evidence was introduced on this issue.

Regulatory statutes obligate the Commission to set "just and reasonable" rates. *See* Minn. Stat. § 237.075, subd. 6. By requiring Northwestern Bell to give away services free of charge without considering the actual effect upon Northwestern Bell's rate of return, the Commission has violated its responsibility to ensure that Northwestern Bell may charge reasonable rates.

Respondents point to evidence that the markup for the Touch-Tone services is 1,567%, and argue that other ratepayers will make up the revenue lost by the provision of the free services to the handicapped customers. Respondents also not that those persons eligible for the free Touch-Tone and Speed Call 8 services must continue to pay charges for basic local service.

The record indicates only the Northwestern Bell's other non-handicapped, customers will be paying for all Touch-Tone and Speed Call 8 services. It does not, as respondents argue, demonstrate that other ratepayers will "make up the revenue foregone" by providing free services to handicapped customers. We therefore conclude that this portion of the Commission's order must be reversed.

We have considered Northwestern Bell's other arguments and find them to be without merit.

DECISION

Affirmed in part and reversed in part.

December 22, 1987 Susanne C. Sedgwick

APPENDIX 12

STATE OF MINNESOTA
IN SUPREME COURT
C7-87-1296 and C9-87-1297

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commission. (C7-87-1296)

In the Matter of the Petition of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota. (C9-87-1297)

ORDER

Based upon all the files, records and proceedings, herein,

IT IS HEREBY ORDERED that the petition of Northwestern Bell Telephone Company for further review be, and the same is, denied.

Dated: 3-18-88

BY THE COURT:

Chief Justice

APPENDIX 13

C7-87-1296
C9-87-1297

STATE OF MINNESOTA
IN SUPREME COURT

Northwestern Bell Telephone Company,

Petitioner,

v.

Minnesota Public Utilities Commission,

Respondent.

PETITION FOR RECONSIDERATION

Northwestern Bell Telephone Company ("NWB") hereby petitions the Minnesota Supreme Court pursuant to Rule 140.01 of the Minnesota Rules of Civil Appellate Procedure for reconsideration of its Order dated March 18, 1988, denying NWB's petition for further review. The Supreme Court's decision let stand a decision of the Court of Appeals dated December 28, 1987, which affirmed two orders of the Minnesota Public Utitilies Commission ("the Commission"). These orders re-opened a three-year-old final telephone rate case and prospectively lowered NWB's revenue by over $12 million annually. In the opinion of NWB, the Supreme Court has overlooked, failed to consider, misapplied or misconceived the following material questions involving constitutional and statutory issues:

1. Whether the federal district court's explicit order in *United States v. American Telephone & Telegraph Co.*, 552 F. Supp. 131

(D.D.C. 1982), that NWB's capital structure consist of 45 percent debt and 55 percent equity pre-empted the Commission's authority to impose on NWB a radically different hypothetical capital structure, thus depriving the Commission of jurisdiction to take such action.

2. Whether the Commission's refusal to permit NWB argument in the reconsideration of the rate case (which thus precluded NWB from orally arguing to the newly constituted Commission that its capital structure was mandated by federal court order) violated the Supreme Court's October 1987 opinion in *In re The Petition of Northern States Power Co.*, 414 N.W.2d 383, 388 (Minn. 1987) ("*NSP*"), Minnesota Statutes Section 14.57, and deprived NWB of its right to due process guaranteed by the Minnesota and United States Constitutions.

3. Whether, by depriving NWB of a fair return on its investment, the Court of Appeals' and the Commission's decisions violated the just compensation clause of the Fifth Amendment to the United States Constitution, the Minnesota Constitution and section 237.075, subd. 6 of the Minnesota Statutes.

4. Whether the failure by the Commission to use contested case hearing procedures in connection with the investigation by the Department of Public Service into contacts between NWB and the Public Utilities Commission constituted a denial of NWB's right to due process guaranteed by the Constitutions of Minnesota and the United States, and a violation of Minnesota Statutes.

5. Whether the failure of the Commission to explain its denial of NWB's petition for reconsideration, which raised many new issues and arguments, violated Minnesota Statutes, section 14.62(1) and established Minnesota case law.

ARGUMENT

In determining in 1987 that its order in the 1984 rate case should be re-decided, and in issuing its new rate order, the Commission violated significant rights of NWB guaranteed by the federal and state Constitutions.

1. The Pre-Emption Doctrine of the United States Consitution Deprived the Commission of Jurisdiction to Impose a Hypothetical Capital Structure in Its 1987 Decision.

The largest single component of the Commission's 1987 reduction of NWB's rate increase resulted from its rejection of NWB's actual capital structure (which had been approved by the Commission in 1984 and agreed to by the Attorney General, Residential Utilities Division) and the imposition in its stead of a hypothetical capital structure with a higher debt ratio.[1] The Commission's 1987 imputation of that hypothetical capital structure to NWB, which was affirmed by the Minnesota Court of Appeals, was pre-empted by federal law, and the Commission thus lacked jurisdiction to take that action.

On August 24, 1982, the United States District Court for the District of Columbia entered an order known as the Modification of Final Judgment in the federal government's antitrust action against American Telephone and Telegraph Company ("AT&T") and certain affiliated companies. *United States v. American Telephone & Telegraph Co.*, 552 F. Supp. 131 (D.C.D.C. 1982). In its action, the United States had alleged Sherman Act violations and sought the divestiture from AT&T of the Bell Operating Companies. *Id.* at 139. Northwestern Bell was one of those Bell Operating Companies. After years of litigation, and at the conclusion of the presentation of the Justice Department's and AT&T's cases in chief at trial, the parties agreed to a consent decree that provided for the divestiture of the Bell Operating Companies and set forth in detail structural changes containing restrictions designed to prevent the Operating Companies from discriminating against AT&T's competitors, and to avoid a recurrence of the types of discriminating cross-subsidizations that were alleged to be the basis of the lawsuit. *Id.* at 142–143.

The Court carefully scrutinized the proposed consent decree pursuant to the requirements of the Tunney Act, 15 U.S.C. § 16(e), which provides that a proposal for a consent judgment submitted by the United States in an action brought under the antitrust laws may not be entered by the court without prior compliance with certain procedures, including a determination by the court that the entry of the judgment is in the public interest. In making that determination, the court is to consider, among other things, the

impact of the entry of such judgment upon the public generally, as well as the competitive impact of the judgment and its impact upon individuals alleging specific injury from the alleged violations. The procedures required by the Act include a 60-day comment period, publication of a competitive impact statement by the Department of Justice, and a 60-day period for the receipt of public comments. In analyzing the Tunney Act's requirement, the court stated: "It is clear that Congress wanted the courts to act as an independent check upon the terms of decrees negotiated by the Department of Justice, and this Court will review the instant settlement in that spirit." *Id.* at 149 (footnote omitted).

In satisfying these obligations imposed by the Tunney Act, the federal district court evaluated the debt-equity ratios to be assumed by the Operating Companies. *Id.* at 207–208, 226. AT&T had stated its intention, to which the government agreed, to divest the Operating Companies, such as NWB, with a debt ratio of approximately 45 percent. The Court required the proposed consent decree to be modified to incorporate a 45 percent debt ratio, saying:

> The Court considers that its Tunney Act responsibilities require it demand more of the parties on subjects which have significant public interest aspects than statements of intention embodied in briefs or written comments, or made during oral argument. Accordingly, **the Court will require** that the proposed decree be modified to incorporate the forty-five percent debt ratio and the government's and AT&T's representations with regard to the quality of the Operating Company debt, to the end that on the basis of such a modification the Court will be in a position, if necessary, to insist that the statements of intention of the parties are actually implemented.

Id. at 207–08 (emphasis supplied).

It its Order modifying the final judgment, the court stated:

> At the time of the transfer of ownership provided for in section I(A)(4), **the separated BOCs shall have debt ratios of approximately forty-five percent** (except for Pacific Telephone & Telegraph Company which shall have a debt ratio of approximately fifty percent), and the qual-

> ity of the debt shall be representative of the average terms and conditions of the consolidated debt held by AT&T, its affiliates and the BOCs at that time. Upon application by a party or a BOC, the Court may grant an exception to this requirement.

Id. at 226 (emphasis supplied).

The Court's decision was not contingent upon the state regulators' approval of these debt-equity ratios. One of the Bell operating companies, Pacific Telephone, had at the time of Modification of Final Judgment a substantially higher debt-equity ratio of approximately 57 percent. The Court did not require AT&T to reduce Pacific Telephone's debt to 45 percent, but accepted a reduction of Pacific's debt to around 50 percent. The Court did not condition its order on approval by the State of California of the ratio. Thus, in assessing its obligations created by Congress in the Tunney Act, the federal district court imposed an obligation on Pacific Telephone & Telegraph to use a 50 percent debt-equity ratio, notwithstanding the use by California regulators of a debt-equity ratio as high as 57 percent. *Id.* at 208 n.320.

In 1983, several parties to the antitrust case attempted to convince the Court that the capital structure imposed by the Modification of Final Judgment was inequitable, in part because the various Bell Companies operated under different tariffs. The Court disagreed, saying:

> Because the decree provides that the Operating Companies and AT&T will each receive a portion of the consolidated debt and equity of the Bell System[59], it is reasonable for each of the post-divestiture entities also to receive a corresponding portion of the system's pre-divestiture business risks which encumber equity.

---

[59] The decree provides that AT&T is to divest the Operating Companies with 45 percent debt ratios (55 percent equity) . . . .

United States v. Western Electric Co., Inc., 569 F. Supp. 1057, 1072 (D.D.C. 1983).

The federal court order has pre-empted the state from imposing

a hypothetical capital structure that would violate that federal court order. Federal law pre-empts state law when state law actually conflicts with federal law, which arises when compliance with both federal and state law is impossible. *Michigan Canners & Freezers Ass'n., Inc. v. Agricultural Marketing and Bargaining Board,* 467 U.S. 461, 469 (1984). In that case, the Supreme Court held that the state law at issue was pre-empted by the federal legislation, because the state law authorized agricultural producers associations to engage in conduct prohibited by federal law. *Id.* at 478. In this case, the Commission has ordered that it was unreasonable for NWB to use the capital structure ordered by the federal district court, thus requiring NWB to engage in conduct prohibited by federal law or penalize it for failing to engage in such conduct.

In 1984, Northwestern Bell argued that the use of any hypothetical capital structure containing less than 55 percent equity would be "patently unfair and unlawful, regardless of the evidence." Initial Brief, April 30, 1984, at pp. 159-160. Northwestern Bell specifically argued that the federal court's order mandating divestiture of the Bell Operating Companies had required them to have debt ratios of approximately 45 percent and that the imposition of a capital structure using less than 55 percent equity would conflict with the order of the United States District Court. In 1984, the Commission's decision was in compliance with the debt ratio set by the federal court's divestiture order. In its 1987 order after redeliberation, however, the Commission imposed a debt-equity ratio of 50.1%, thus imputing to NWB a capital structure that would not have been in compliance with the Modification of Final Judgment. Both in 1984 and in redeliberation in 1987, the Commission's rate decisions were based on 1983 test year data, adjusted to reflect the effects resulting from the divestiture order. The 1987 imputation of the hypothetical debt ratio is barred by the pre-emption doctrine and thus violates the United States Constitution.

Other state utility regulatory commissions have agreed that for the post-divestiture period, the capital structure requirements of the federal court's Modification of Final Judgment control for ratemaking purposes. In *Illinois Bell Telephone Co.,* 57 P.U.R. 4th 225, 263 (Ill. Comm. Comm'n 1983), the Illinois Commerce Commission refused to impute a hypothetical capital structure as a result of the Modified Final Judgment. In *Chesapeake Potomac Tel. Co.,* 74

Md. P.S.C. 595 (1983), the Maryland Public Service Commission reached the same result, saying:

> We are persuaded that the MFJ (the federal court order) **leaves no alternative** other than for C&P Telephone Company of Maryland to be divested with a capital structure which is not in excess of 45 percent debt. Since this is a legal requirement established by the U.S. District Court and is binding upon AT&T as well as the divested local operating companies, we conclude that we should adopt a capital structure that conforms with that requirement. . . . As a consequence, the Modification of Final Judgment will establish, for practical purposes, the maximum amount of debt capital which will comprise the Company's capital structure throughout much of the rate-effective period.

(emphasis supplied).

Respondents argued in opposition to the Petition for Review that the Supreme Court, in its recent decision in *In re Northern States Power,* 414 N.W.2d 383 (1987) had already approved the Commission's authority to impose a hypothetical capital structure. That argument overlooks the critical fact that NWB's capital structure was mandated by federal court order. NSP was subject to no such federal order. The *NSP* decision, therefore, does not control with respect to NWB's capital structure.

2. The Refusal to Permit Oral Argument in the 1987 Reconsideration of the Rate Case Constitutes a Denial of NWB's Right to Due Process.

After the Commission decided in 1987 to re-open the 1984 rate case, it re-decided that case on the basis of the record of the prior proceeding. The Commission did not permit NWB oral argument in its re-decision of this rate case, despite the express requirement of Minnesota Statues section 14.61 that it do so. As a result, the Commission's action, affirmed by the Court of Appeals, violates fundamental principles of due process and fairness, as well as Minnesota Statutes section 14.61.

In essence, the Court of Appeals ruled that NWB was not

entitled to oral argument because its ex parte contacts with the Commission denied it the right to be treated fairly. Constitutional rights, however, cannot be violated by merely espousing equitable maxims. NWB had a constitutional right, expressly recognized by statute, to present argument to those Commission members deciding a highly complicated rate case, in which $57 million of rate relief had previously been deemed necessary to afford a reasonable return to NWB's shareholders. The basis on which oral argument was denied to NWB was arbitrary, capricious, and punitive. As a result, that denial of oral argument constituted a violation of NWB's constitutionally protected right to due process.

3. The Commission's Redeliberated Order Violates the United States and Minnesota Constitutions by Depriving NWB of a Reasonable Return on its Investment.

The Fifth Amendment to the United States Constitution provides that private property shall not be taken for public use without just compensation, and it is enforceable against the States through the Due Process Clause of the Fourteenth Amendment. *Webb's Fabulous Pharmacies, Inc. v. Beckwith,* 449 U.S. 155, 159 (1980). The Minnesota Constitution similarly requires just compensation when private property is taken for public use. Minn. Const., Art. I, § 13. In the context of public utility rate regulation, the requirement of just compensation is met only if the rates permit the utility to earn a reasonable rate of return on its investment. *West v. Chesapeake & Potomac Tel. Co.,* 295 U.S. 662, 671 (1935); *Bluefield Waterworks & Improvement Co. v. Public Service Comm'n,* 262 U.S. 679 (1923); *Hibbing Taconite Co. v. Minnesota Public Service Comm'n,* 302 N.W.2d 5, 10 (Minn. 1981). The Commission also has a statutory duty to set rates at a level which ensures a fair and reasonable return on NWB's investment. Minn. Stat. § 237.075, subd. 6. The Commission's Order violates this constitutional protection.

By imputing a hypothetical capital structure to NWB, the Commission chose to ignore the reality that NWB's capital structure is mandated by the federal court's divestiture order in *United States v. American Telephone & Telegraph Co., supra.* Its imputation of a hypothetical capital structure requires the assumption that NWB

would use the capital structure that it was actually prohibited from using by federal court order. The company simply cannot earn a fair and reasonable return on its investment if the hypothetical capital structure imposed by the Commission is used to set that rate of return. Similarly, by imputing directory service revenues to NWB that it could have hypothetically earned, in the face of the Court of Appeals' earlier reversal of the Commission's order requiring NWB to engage in those directory operations, the 1987 decision has a confiscatory result. The Commission has thus prevented NWB from earning a fair return on its investment in violation of the Minnesota and United States Constitutions and state statutes.

4. The Failure to Permit NWB the Opportunity to Cross-Examine Witnesses or to Otherwise Use Contested Case Hearing Procedures Deprive NWB of its Constitutionally Guaranteed Rights to Due Process and Violates Minnesota Statutes.

The Commission's re-opening of the 1984 rate case was based on an investigation by the Department of Public Service of contacts between NWB and the Commisison. Because the Commission was engaged in a rate-making proceeding involving disputed facts, it was required by Minnesota Statutes, Section 237.075, and the Minnesota Administrative Procedure Act to use contested case hearing procedures in re-opening the case. *State v. Tri-State Tel. & Tel. Co.*, 284 N.W. 294 (1939); *see, Continental Tel. Co. of Minn., Inc.*, 389 N.W.2d 901 (Minn. 1986). The Commission, however, did not use contested case hearing procedures as required by law.

The Department of Public Service produced a report of its investigation of contacts between NWB and Commission members. Instead of conducting a contested case proceeding into whether the rate case should be re-opened, the Commission merely took administrative notice of that report, together with depositions taken by the Department of Public Service and other exhibits. Many of these exhibits consisted of affidavits and memoranda of interviews or telephone conversations with individuals conducted by the Department of Public Service. NWB had neither prior notice of these interviews or the preparation of these Affidavits, nor the opportunity to cross-examine the witnesses involved in them. Many of the exhibits to the report were not disclosed to NWB until after the DPS report was filed. The Commission rebuffed NWB's objection

to such documents serving as the basis for the Commission's action. As a result, NWB was denied its fundamental due process rights guaranteed by the federal and state constitutions and Minnesota statutes.

5. The Commission's Failure to Make Findings on Substantive Issues Raised by NWB in 1987 Violated Minnesota Statutes and Evidences the Arbitrary and Capricious Nature of its Decision.

The Commission is required to deal fairly with all material issues raised by the parties and to make findings sufficient to allow meaningful appellate review. *Hibbing Taconite Co. v. Minnesota Public Service Commission,* 302 N.W.2d 5, 12 (Minn. 1980). The failure to do so indicates that the Commission has not engaged in reasoned decision-making, and has exercised its will rather than its judgment. *Yellowbird, Inc. v. MSP Express, Inc.,* 377 N.W.2d 490, 494 (Minn. App. 1985). Many substantive issues were raised by NWB in its Petition for Reconsideration of the Commission's 1987 Order after its redeliberation of the earlier rate case, because the Commission had not allowed written submissions from NWB earlier. The new issues included the reversal by the Court of Appeals of a decision on which the Commission had relied, and the argument that the imputation of directory revenues to NWB was contrary to both Minnesota Supreme Court decisions and the decision of the Court of Appeals on this very issue in this rate case in 1986.

In response, the Commission merely claimed that nothing new had been raised in the Petition, stated that all matters had been thoroughly considered, and failed to even mention the new issues. The Court has the duty to intervene when a combination of danger signals suggests that the agency has not taken a hard look at the salient problems and has not genuinely engaged in reasoned decision-making. *Yellowbird, supra,* 377 N.W.2d at 493; *Reserve Mining Co. v. Herbst,* 256 N.W.2d 808, 824–25 (Minn. 1977). The absence of contested case hearing procedures, the reliance on inadmissible documents, the refusal to follow statutory procedures, the denial of a requested oral argument, the refusal to articulate reasons for decision of key issues, and the overall emphasis on a punitive result compel the conclusion that the Supreme Court must exercise its duty to review this case.

CONCLUSION

NWB respectfully petitions the Supreme Court to reconsider the denial of NWB's Petition for Supreme Court review of the decision of the Court of Appeals. NWB believes that in denying the Petition for Review, the Supreme Court has overlooked, misconstrued or misapplied federal and state constitutional principles as well as state statutes. Specifically, NWB claims that the Commission's action:

1. Has denied NWB due process required by the Federal and State Constitutions and by Minnesota statute;
2. Was pre-empted by federal law;
3. Constitutes a taking of NWB's property without just compensation in violation of the federal and state Constitutions and Minnesota statutes;
4. Violates the Administrative Procedures Act, Minn. Stat. §§ 14.61 and 14.52, subd. 1;
5. Violates the protections guaranteed to a utility by the rate-making statute, Minn. Stat. § 237.075; and
6. Violates the statutory requirement that approved telephone rates be observed until changed as provided by statutory procedures, Minn. Stat. § 237.075, subd. 5.

For the foregoing reasons, as well as those urged in NWB's Petition for Further Review dated January 27, 1988, NWB requests that the Court reconsider its Order dated March 18, 1988, denying further review.

March 28, 1988

APPENDIX 14

STATE OF MINNESOTA
IN SUPREME COURT
C7-87-1296 and C9-87-1297

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commission. (C7-87-1296)

In the Matter of the Petition of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota. (C9-87-1297)

ORDER

Based upon all the files, records and proceedings, herein,

IT IS HEREBY ORDERED that Northwestern Bell Telephone Company's petition for reconsideration of the denial of its petition further review be, and the same is, denied.

Dated: April 4, 1988

BY THE COURT:

Chief Justice

Supreme Court, U.S.
FILED
AUG 5 1988
JOSEPH F. SPANIOL, JR.
CLERK

(3)

No. 88-38

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

NORTHWESTERN BELL TELEPHONE COMPANY,
Petitioner,

v.

MINNESOTA PUBLIC UTILITIES COMMISSION,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE MINNESOTA COURT OF APPEALS

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

(1) Whether the federal issues identified in the Petition for Writ of Certiorari were adequately raised before the state court of appeals.

(2) Whether Petitioner failed to exhaust available state avenues of review of its federal claims.

(3) Whether the identified issues present substantial federal questions.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

No. 88-38

NORTHWESTERN BELL TELEPHONE COMPANY

Petitioner,

v.

MINNESOTA PUBLIC UTILITIES COMMISSION,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE MINNESOTA COURT OF APPEALS

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

JURISDICTION

As petitioner states, jurisdiction is premised on 28 U.S.C. § 1257(3) (1966 and Supp. 1988). However, as shall be fully developed in this Brief in Opposition, jurisdiction to review the identified federal issues is not properly invoked because these issues were neither pressed before nor passed on by the Minnesota Court of Appeals. Additionally, the federal issues presented are insubstantial and do not merit review.

STATEMENT OF THE CASE

This Brief in Opposition is submitted on behalf of respondent Minnesota Public Utilities Commission and intervenor-respondents Minnesota Department of Public Service and the Minnesota Attorney General (hereafter "Respondents").

The Respondents adopt and incorporate the statement of facts contained in the Minnesota Court of Appeals decision, *Minnesota Public Utilities Commission's Initiation of Summary Investigation,* 417 N.W.2d 274 (Minn. App. 1987).

Additionally, however, specific corrections must be made to Northwestern Bell Telephone Company's ("NWB" or "Bell") Statement of the Case. With respect to its appeal to the Minnesota Court of Appeals, NWB did not claim that denial of oral argument was a violation of federal constitutional rights.[1] NWB Brief in C9-87-1297 at 42-46, R A 97-99. Although NWB argued before the Court of Appeals that "due process" required a formal hearing, NWB relied on state statutes and law.[2] NWB Brief in C9-87-1296, at 47-49, R A 48-51. NWB did not raise the preemption claim before the Court of Appeals.

Similarly, NWB's petition for Minnesota Supreme Court review was entirely silent with respect to federal claims.

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[1] In order to permit the Court to fully explore NWB's failure to raise its federal issues below, respondents have included in their appendix copies of NWB's initial briefs before the Minnesota Court of Appeals as well as NWB's Petition for Supreme Court Review. References to Respondents' appendix will be denoted R A and references to the NWB appendix shall be referenced as NWB A.

[2] The only reference to federal law consists of a single statement made in the course of analyzing a state case, *Matter of Haugen,* 278 N.W.2d 75 (1979). During that discussion, NWB stated: "Such basic fairness is guaranteed by the state and federal constitutions." NWB Brief in C9-87-1297 at 46, R A 99.

Instead, only state law claims were pressed. NWB Petition for Supreme Court Review, R A 103. NWB raised its federal issues for the first time before the Minnesota Supreme Court in its Petition for Reconsideration. NWB A-204. That petition, however, did not raise the due process claims now identified and briefed by NWB. Rather, NWB asserted only that denial of oral argument violated due process rights. Here, however, NWB alleges that its due process rights were violated by a failure to hold an evidentiary hearing as well as its oral argument claim. *Id.* NWB A-120.

REASONS FOR DENYING THE PETITION FOR WRIT OF CERTIORARI

As shall be shown, Northwestern Bell Telephone Company's Petition should be denied because: 1) NWB failed to adequately raise before the Minnesota Court of Appeals, the federal issues it relies upon in its petition nor did the Court of Appeals rule on any federal claims; 2) NWB failed to exhaust state avenues of review of its federal claims; and 3) NWB's federal issues are insubstantial and do not warrant U.S. Supreme Court review.

I. NWB DID NOT PRESS ITS FEDERAL ISSUES BELOW.

A. The Standard For Review By Writ Of Certiorari.

The Supreme Court's jurisdiction to review decisions of state courts derives from 28 U.S.C. § 1257 (1966 and Supp. 1988), which provides:

> [F]inal judgments or decrees rendered by the highest court of a state in which a decision may be had, may be reviewed by the Supreme Court as follows: . . . By writ

> of certiorari, where any title, right, privilege or immunity is specially claimed under the Constitution, treaties, or statutes of . . . the United States.

Essentially, this provision has descended from the Judiciary Act of 1789, § 25, Stat. 85.

The Supreme Court established early on that Section 25 of the Judiciary Act provided jurisdiction only over those federal questions which had been both raised and decided in the relevant state court. *Crowell v. Randall*, 10 Pet. 368, 392 (1836); *see also Owings v. Norwoods' Lessee*, 5 Cranch 344 (1809). This principle developed into the rule that a federal question must be pressed or passed on below as a prerequisite to invoking Supreme Court review. *McGoldrick v. Compagnie Generale Transatlantique*, 309 U.S. 430, 434-36 (1940). That is, either the relevant state court decision must discuss and decide the federal issue or the issue must be raised before that court by the petitioner. Although it is unclear whether the "pressed or passed on below" rule is jurisdictional in nature or merely prudential, *Illinois v. Gates*, 462 U.S. 213, 219-22 (1986), the Supreme Court continues to adhere to the rule that, absent exceptional circumstances, the Court will review by writ of certiorari only those federal questions or issues argued before or expressly decided by the state's court of last resort. *McGoldrick, supra*, 309 U.S. at 434-35.

The federal issues identified by NWB in its petition do not meet this standard. Because the Minnesota Supreme Court denied NWB's petitions for review, NWB seeks a writ of certiorari to the Minnesota Court of Appeals. *See Minneapolis, St. Paul & S.S.M. Ry. Co. v. Rock*, 279 U.S. 410 (1929) (Court of Appeals is the highest state court when state supreme court denies discretionary review). Therefore, whether NWB's alleged federal claim meets the "pressed or passed on

below" rule will be tested by the litigation of these issues before the Court of Appeals. The record demonstrates that NWB cannot meet that standard. The federal issues were neither pressed before nor passed on by that court. First, the Court of Appeals decision does not address the identified federal issues. Second, NWB either wholly failed to raise federal issues before the Court or raised them in a perfunctory and insufficient fashion.

B. The Court Of Appeals Did Not Pass On The Federal Issues.

A thorough reading of the Court of Appeals decision, *In the Matter of the Minnesota Public Utilities Commission's Summary Investigation*, 417 N.W.2d 274 (Minn. App. 1987), NWB A-181, reveals that the federal issues identified by NWB in its petition before this Court were not discussed or ruled upon by the Minnesota Court of Appeals.

In its Petition, NWB lists three federal issues: preemption, due process, and confiscation. In the Court of Appeals' decision there is absolutely no mention of NWB's alleged preemption issue or confiscation. With respect to due process, the opinion does state simply that NWB alleged that Commission procedures violated Northwestern Bell's "constitutional and statutory rights." *Id.* at 278, 283. For example, the Court stated: "Northwestern Bell claims the denial of oral argument before the new Commissioners in 1987 constituted a deprivation of its constitutional and statutory rights." Although the Opinion does not identify whether "constitutional" is used in the state or federal sense, it is clear from the Court's analysis of NWB's claim of improper Commission procedures that it was addressing only state law. *Id.*

Based on the four corners of the opinion, the Court of Appeals did not pass on the alleged federal issues now identi-

fied in NWB's petition. Therefore, NWB cannot invoke Supreme Court jurisdiction on the ground that the Minnesota Court of Appeals actually decided the identified federal issues.

C. NWB Failed To Press Its Federal Issues Before The Minnesota Court Of Appeals.

There is a sound reason why the Court of Appeals failed to address NWB's federal issues: NWB either failed to raise the issues or failed to raise them adequately before the Court of Appeals. In similar situations the Supreme Court has observed:

> [W]hen the highest state court has failed to pass upon a federal question, it will be assumed that the omission was due to want of proper presentation in the state courts, unless the aggrieved party in this Court can affirmatively show the contrary.

Street v. New York, 394 U.S. 576, 582 (1969); and *see Exxon Corp. v. Eagerton,* 462 U.S. 176, 181 n. 3 (1983). That assumption is borne out by the facts of this case.

First, NWB's Briefs on appeal were entirely silent with respect to the preemption issue. This silence is fatal to the reviewability of this issue. Since the Court of Appeals did not address the issue and NWB failed to raise it before that court, there can be no doubt that the preemption issue fails to meet the "pressed or passed on below" standard necessary to invoke Supreme Court jurisdiction.[3]

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[3] The preemption issue was raised before the Commission. NWB A-169. NWB's position was seriously undermined, however, by the testimony of its own witness who requested that the Commission use an equity ratio which did not conform to the debt equity ratios which NWB now claims are required as a matter of federal law. NWB A-148.

According to this Court's standards, the remaining issues identified by NWB in its Petition for Certiorari, procedural due process and confiscation, were inadequately raised by NWB before the Court of Appeals. In order to invoke U.S. Supreme Court jurisdiction, a petitioner must bring the federal claim and the grounds for that claim before the state court with some specificity. In a related jurisdictional context, the Supreme Court has stated: "No particular form of words or phrases is essential, but only that the claim of invalidity and the ground therefore be brought to the attention of state courts with fair precision and in due time." *New York ex rel. Bryant v. Zimmerman,* 278 U.S. 63, 67 (1928). If the federal issue is not adequately presented, Supreme Court review cannot be invoked. For example, the Court has rejected petitions where only a mere reference was made to the "Constitution of the United States," *Herndon v. Georgia,* 295 U.S. 411 (1935), or "due process of law," *Bowe v. Scott,* 233 U.S. 658 (1963). Moreover, if a claim is made only that a statute or action denies "constitutional rights," the Supreme Court will assume that the reference was addressed to the state constitution. *New York ex rel. Bryant v. Zimmerman, supra.* The reason federal issues must be adequately raised in the state court is to ensure that Supreme Court jurisdiction is conserved for mature federal issues, and not simply for preliminary, unspecified, and unlitigated federal claims.

Judged by these standards, NWB has failed to adequately raise its federal claims. With respect to the due process issue, in its Brief before the Court of Appeals, NWB failed to claim violation of the federal constitution with any specificity. Rather, NWB vaguely mentioned, in an off-hand manner, "contitutional rights" or "due process." In fact, NWB's discussion of procedural due process included no federal law.

NWB Brief in C7-87-1296, at 46-49, R A 48-51; NWB Brief in C7-87-1297, at 44-46, R A 97-99. Indeed, NWB made none of the arguments below which it now raises in its Petition.[4] Instead of identifying federal constitutional provisions or case authority, NWB relied exclusively on state law with respect to its procedural claims. In the absence of reliance on federal authority, its "claim" should be construed as implicating the state, rather than the federal, constitution. *New York ex rel. Bryant v. Zimmerman, supra.* NWB's inadequate presentation of its "federal" due process claim does not comport with the policies undergirding Supreme Court review.

NWB's presentation of the confiscation issue is similarly deficient. The analysis of confiscation in the regulatory context focuses on the effect of the particular regulatory action on the continuing financial health and integrity of the utility. The operative standards with respect to confiscation were established by the Supreme Court in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). In that case the Court stated:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the

---

[4] It also appears that NWB has altered its procedural claim at every stage of review. Before the Court of Appeals NWB relied on state statutory and case law for its argument that it was improperly denied oral argument. NWB Brief in C7-87-1296, at 46-49, R A 48-51; NWB Brief in C7-87-1297, at 44-46, R A 97-99. NWB's Petition For Supreme Court Review did not allege due process claims. R A 103. In its Petition for Reconsideration in the Minnesota Supreme Court, NWB first argued that denial of oral argument implicated federal law. NWB A-205. Now, for the first time, NWB appears to contend that it should have been accorded a full blown evidentiary hearing before an independent administrative law judge before the redeliberation of its rates by the Commission. Petition at 14.

> business. These include service on the debt and dividends on the stock . . . . By that standard the return to the equity owner should be commensurate with returns on investment in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Id. at 603 (citations omitted).

A determination of the type described in *Hope* is factually and legally complex. *See Jersey Central Power and Light v. F.E.R.C.*, 810 F.2d 1168, 1170-72 (D.C. Cir. 1987). Therefore, this type of claim requires in-depth factual support. Yet NWB's presentation of this issue contains no analysis beyond a barren citation of two cases. NWB Brief in C7-87-1296 at 49, R A 51. NWB presented no facts to the Court of Appeals regarding NWB's financial health, nor did it make appropriate citations to the record to support this claim. No court could have analyzed this complex claim based on such a presentation.[5] Supreme Court review should not be wasted on an alleged issue that was treated like a throw-away claim by NWB.

D. Policy Considerations.

The requirement that a federal claim be adequately presented to the state court is not a sterile, formal requirement. Indeed, in the absence of an adequate presentation, the state court will not have the opportunity to address and dispose

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[5] As stated above, the Court of Appeals did not address this claim on the merits. The probable state ground for rejection of this claim is failure to meet its burden of proof. In Minnesota, the burden of proof for any issue in a rate action is always with the utility. *Petition of Continental Telephone Co.*, 389 N.W.2d 910, 915 (Minn. 1986).

of the federal question itself, perhaps foreclosing the necessity of further review. Moreover, an inadequate presentation will result in an inadequate record for ultimate Supreme Court review. These considerations lie at the heart of the requirement that a claim be pressed and passed on before the state's highest court. In this regard, the Court stated in *Cardinale v. Louisiana*, 394 U.S. 437, 439 (1968):

> In addition to the question of jurisdiction arising under the statute controlling our power to review final judgments of state courts, 28 U.S.C. § 1257, there are sound reasons for this. Questions not raised below are those on which the record is very likely to be inadequate, since it certainly was not compiled with those questions in mind. And in a federal system it is important that state courts be given the first opportunity to consider the applicability of state statutes in light of constitutional challenge, since the statutes may be construed in a way which saves their constitutionality. Or the issue may be blocked by an adequate state ground. Even though States are not free to avoid constitutional issues on inadequate state grounds, *O'Connor v. Ohio*, 385 U.S. 92 (1966), they should be given the first opportunity to consider them.

The record in this case provides an inadequate basis for review in the Supreme Court of the identified federal issues. As stated above, conclusory statements concerning "due process" or "confiscation" provide no sound basis for meaningful state court review below nor do they produce a sufficiently narrowed issue for a review by this Court. Instead, the record should contain legal arguments and the facts supporting those arguments. The record here does not. Moreover, the state courts could have resolved these issues on adequate state

grounds if given an opportunity.[6] Because of the inadequate presentation of federal issues, the Minnesota courts were deprived of this opportunity. Indeed, the absence of such a record explains the absence of any discussion of federal issues by the Court of Appeals.

Therefore, in absence of adequate presentations of federal issues and an adequate record for review of those issues, NWB's Petition for a Writ of Certiorari should be denied both on jurisdictional and policy grounds.

II. NWB FAILED TO EXHAUST AVAILABLE STATE AVENUES OF REVIEW.

Northwestern Bell's Petition also should be denied because it failed to exhaust state avenues of appeal on its identified federal claims. Even when certiorari is directed to an intermediate court of appeals, available discretionary review must be pursued to insure that the highest state court has an opportunity to address the federal issues. *Banks v. California,* 395 U.S. 708 (1969); *Benton v. Maryland,* 395 U.S. 784, 786 (1969). If the petitioner fails to use the opportunity to raise federal issues on further appeal, the petitioner will be considered to have waived such issues. *Herndon v. Georgia,* 295 U.S. 441 (1935); *Beatty v. Richardson,* 276 U.S. 599 (1928). Such is the case here.

NWB failed to exhaust available review of its federal claims when it elected to address only state issues in its Petition for Review in the Minnesota Supreme Court. No federal issues were claimed or discussed. *See* Petition for Supreme Court Review, R A 103. Instead, the federal issues which NWB now lists in its Petition for Writ of Certiorari were first

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[6] See fn. 5, *supra.*

presented to the Minnesota Supreme Court in NWB's Petition for Rehearing. NWB A-204-214. Contrary to the allegations contained in NWB's Petition for Writ of Certiorari, at 9 n.1, this presentation of issues on rehearing was not adequate to preserve its federal claims because the Petition for Rehearing failed to meet state procedural requirements for securing a rehearing. *Minn. R. App. P. 140.01.*[7] As a consequence, NWB failed to give the Minnesota Supreme Court a meaningful opportunity to address its alleged federal issues. This failure to seek appropriate review in the state supreme court is, in turn, fatal to NWB's Petition for Certiorari because the failure is considered a waiver of the federal issues. *Herndon, Beatty, supra.*

This result is consistent with the longstanding rule that federal questions first presented to the state's highest court

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[7] Minn. R. App. P. 140.01 provides as follows:

> No petition for rehearing shall be allowed in the Court of Appeals.
>
> A petition for rehearing in the Supreme Court may be filed within 10 days after the filing of the decision or order unless the time is enlarged by order of the Supreme Court within the 10-day period. The petition shall set forth with particularity:
>
> (a) any controlling statute, decision or principle of law; or
>
> (b) any material fact; or
>
> (c) any material question in the case which, in the opinion of the petitioner, the Supreme Court has overlooked, failed to consider, misapplied or misconceived.

NWB's Petition for Rehearing failed to meet the requirements of this section because the issues identified had never been raised before the Supreme Court either by the Court of Appeals opinion or in NWB's original petition for review. Therefore, because of the default in NWB's presentation, these federal issues could not have been overlooked or misapplied by the Supreme Court. In addition, NWB failed to preserve its issues for appeal because it did not press them before the Court of Appeals and in its first petition for review. According to Minnesota law, a party may not raise an issue on appeal not presented to the court below. *Matter of Welfare of K.T.*, 327 N.W.2d 13, 16-17 (Minn. 1982).

in a petition for rehearing come too late to preserve the questions for U.S. Supreme Court review unless the state court actually addresses the federal issues. *Radio Station WOW v. Johnson, Inc.*, 326 U.S. 120, 128 (1945); *American Surety Co. v. Baldwin*, 287 U.S. 156, 162-64 (1932); *Godchaux Co. v. Estopinal*, 251 U.S. 179 (1919); *Consolidated Turnpike Co. v. Norfolk & Ohio R. Co.*, 228 U.S. 326, 334 (1913). If the state supreme court simply refuses the petition, as occurred in this instant case, there is no jurisdiction. *Godchaux Co., supra*, 251 U.S. at 181.

Based upon these standards, it is apparent that NWB's failure to seek meaningful review of its federal claims in the highest available state forum must result in the rejection of its Petition.

III. THE FEDERAL ISSUES RAISED BY NWB ARE INSUBSTANTIAL.

In addition to inadequate litigation in the state courts, NWB's Petition should be rejected because the identified federal issues are insubstantial.

The Supreme Court has determined that insubstantial federal questions are unworthy of review. *E.g. Palmer Oil Co. v. Amerada Corp.*, 343 U.S. 390 (1952). Thus, if an issue is devoid of merit or so explicitly foreclosed by previous decisions that there is no controversy, the Supreme Court will deny review. *Equitable Life Assurance Society v. Brown*, 187 U.S. 308, 311 (1902); *see also Zucht v. King*, 260 U.S. 174 (1922). The issues identified by NWB are insubstantial and do not justify U.S. Supreme Court review.

A. NWB's Preemption Claim Fails Because There Is No Conflict Between The Applicable State And Federal Law.

NWB asserts that the Commission's decision on a capital structure to be used for ratemaking purposes was preempted by a federal court decision, *United States v. American Telephone and Telegraph Co.*, 552 F.Supp. 131 (D.D.C. 1982), involving the breakup of AT&T (the divestiture of AT&T from its local Bell Telephone companies). NWB is incorrect.

As NWB states in its Petition, at 9, in subject matter areas where regulation is shared between the federal government and the states, such as utility regulation, federal law preempts state law only when an actual conflict between the two exists. *See Michigan Canners & Freezers Ass'n. Inc. v. Agricultural Marketing and Bargaining Board*, 467 U.S. 461 (1984). NWB's preemption issue is insubstantial because there is simply no conflict between the state law (the Commission's Order After Redeliberation), and the federal law (the federal district court's decision breaking up AT&T), *United States v. American Telephone and Telegraph Co., supra.*

The purposes of the federal district court decision and the Commission order are so divergent that no conflict exists here. On one hand, the district court's decision (referred to as the Modified Final Judgment "MFJ") authorized a capital structure for AT&T and the local Bell telephone companies for the purposes of divestiture only, and not for ratemaking purposes. The district court's main concern in ordering a capital structure was to assure that the actual capital structure of the newly created local Bell telephone companies conformed to the assets actually transferred to the new companies. Moreover, an actual capital structure was simply a necessary con-

comitant of divestiture: a newly minted corporation must have a capital structure.

The divestiture decision manifested no intent to preempt state regulation. Indeed, the court specifically denied that its actions in the case were intended to bind state ratemaking, stating: "This decision *of course* in no way affects the authority of regulators to use a different standard in valuing assets within their jurisdiction for ratemaking purposes." *Id.* at 205, fn. 312 (emphasis supplied). See also *id.* at 203, fn. 303. In light of the district court's express intention in the divestiture case not to preempt state regulation, the decision should be accorded no preemptive effect on the Commission's Order involved here.

The purpose of the Minnesota Commission's order, in contrast, was ratemaking not effectuating divestiture. In their order the Commission imputed a *hypothetical* capital structure for ratemaking purposes only. NWB A-165-66. The imputation of this *hypothetical* structure did not alter NWB's actual capital structure nor did it interfere in any way with the divestiture ordered by the district court in its Modified Final Judgment. Consequently, NWB is able to have the capital structure ordered by the district court for divestiture purposes while its rates were calculated using a hypothetical capital structure.

NWB attempts to bolster its preemption claim by referencing this Court's most recent preemption decision, *Mississippi Power and Light v. Mississippi*, 56 U.S.L.W. 4751 (No. 86-1970, June 24, 1988). NWB Petition at 11. However, that case has no application here. In *Mississippi Power and Light*, the state commission refused to accept FERC-approved wholesale rates when it established retail rates for the utility. The conflict between the FERC action and the state regulation

arose because both involved ratemaking. Additionally, the FERC intended preemptive effect. As the Supreme Court observed the FERC's order was "the result of a careful balancing of the state and federal interests involved" and that it had paid "careful heed to the impact its decision would have on the states." *Id.* at 4754.

Therefore, the Commission's imputation of a hypothetical structure for ratemaking purposes did not result in a conflict with the MFJ. Significantly, nowhere in the Petition does NWB state that an actual conflict exists. In the absence of a conflict, the preemption argument is foreclosed.

B. NWB's Procedural Due Process Issue Is Routine And Meritless.

NWB alleges that it was denied due process in the handling of the proceedings which resulted in a reopening of an earlier rate case. This procedural claim is insubstantial because it is devoid of merit.

As stated by NWB, the Supreme Court's decision in *Parratt v. Taylor*, 451 U.S. 527 (1981) *overruled in part, Daniels v. Williams*, 474 U.S. 327, 330 (1986) provides the operative standard. In *Parratt*, the Court stated:

> Our past cases mandate that some kind of hearing is required at some time before a State finally deprives a person of his property interests. The fundamental requirement of due process is the opportunity to be heard and it is an "opportunity which must be granted at a meaningful time and in a meaningful manner."

451 U.S. at 540, quoting *Armstrong v. Manzo*, 380 U.S. 545, 552 (1965); *see also Market Street Railway Co. v. Railroad Commission*, 324 U.S. 548, 558 (1945) (notice and hearing required).

The best way to demonstrate that the above procedural standard has been met is to identify the procedural safeguards which occurred in the proceedings below. Before deliberating whether NWB had committed fraud on the Commission, the Commission issued, on October 3, 1986, its *Order Establishing Procedures and Soliciting Briefs,* Docket C1-86-177. That Order requested that the various parties address identified issues involving the merits of whether NWB's earlier 1983 rate case should be redeliberated. NWB A-113. On October 23, 1986 NWB filed comments, as did other interested parties. On November 3, NWB filed Reply Comments. Oral Argument was held on November 6, 1986 and NWB participated. The Commission determined that NWB had committed fraud only after NWB had been accorded the opportunity to meet and contest the issue.

Once the Commission determined that NWB committed fraud on the Commission and vacated the original order, the Commission turned to the proper method for redeliberating the case. Because no intervenor had claimed that the prior evidentiary hearing, which had been conducted by an independent Administrative Law Judge ("ALJ"), had been tainted by NWB conduct, the Commission determined that the most administratively efficient method of redeliberating the case was to begin with the record developed before the ALJ. NWB A-141. Because the earlier evidentiary record was used, NWB enjoyed all the procedural protections provided by the prior administrative procedure, including the opportunity to present issues, cross-examine witnesses and orally argue before the Commission.

NWB was not accorded another evidentiary hearing replete with oral argument for sound reasons. First, a further evidentiary hearing was simply not necessary because the earlier

record adequately reflected the litigated issues and it was free of taint. Second, a further hearing would have rewarded NWB for committing fraud on the Commission. Finally, this procedure is in accord with state law. Indeed, in *Petition of Northern States Power Co.*, 414 N.W.2d 383 (Minn. 1987), the Minnesota Supreme Court ruled that redeliberation on the existing record was the appropriate remedy for correcting tainted Commission deliberations. Therefore, under the unique circumstances of this case, involving fraud on the tribunal, redeliberation on the existing record was the most efficient and fair procedure.[8]

Based on the history of the case, NWB enjoyed the kind of notice and hearing necessary to comport with federal strictures of due process. Moreover, in view of the unique history of this case, involving vacation and re-opening of a rate case because of fraud on the Commission, no substantial federal question exists.

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[8] It is because fraud provides a unique exception to normal administrative procedure that NWB's allegations in its petition carry no weight. For example, NWB claims that "To hold to the contrary would allow a utilities Commission to reduce utility rates without a meaningful hearing as long as a hearing were held at the prior rate determination." Petition at 16. NWB is incorrect because the procedure of redeliberating on the existing record was used only because NWB had committed fraud on the Commission. As a result, routine rate cases will continue to be handled pursuant to *Minn. Stat.* § 237.075 (1986) which provides for administrative hearings before independent law judges.

C. The Confiscation Claim Is Completely Unsupported And Frivolous.

As discussed above, when NWB presented to the Minnesota Court of Appeals its claim that the capital structure granted to it by the Commission results in confiscation, it did so without the support of facts and unencumbered by citations to the record. In the absence of any factual support for this type of complex claim, the confiscation issue must be deemed devoid of merit and, therefore, insubstantial.

Instead of factually supporting its confiscation claim, NWB baldly equated the use of a hypothetical capital structure with confiscation as a matter of law. NWB Brief in C9-87-1296 at 49, R A 51. If NWB is correct, any application of a hypothetical capital structure would result in confiscation. This legal claim is frivolous in light of the settled regulatory practice of approving hypothetical capital structures both in federal and state regulatory jurisdictions. *See Communication Satellite Corp. v. Federal Communications Commission,* 611 F.2d 883 (D.C. Cir. 1977); *General Telephone Company of the Northwest Inc. v. Idaho Public Utilities Commission,* 109 Idaho 942, 712 P.2d 643 (1986) (survey of jurisdictions adopting hypothetical capital structures).

The simplistic equation of a hypothetical capital structure with confiscation demonstrates that this issue is devoid of merit. Moreover, because NWB's confiscation claim merely alleges confiscation without the type of supporting evidence normally submitted, *see e.g. Jersey Central Power and Light v. F.E.R.C.,* 810 F.2d 1168, 1170-1172 (D.C. Cir. 1987), this alleged issue is devoid of merit on a factual basis as well.

CONCLUSION

For the many reasons discussed above, Northwestern Bell's Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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No. 88-38

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

NORTHWESTERN BELL TELEPHONE COMPANY,
Petitioner,

v.

MINNESOTA PUBLIC UTILITIES COMMISSION,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE MINNESOTA COURT OF APPEALS

APPENDIX FOR BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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APPENDIX 1

C7-87-1296

STATE OF MINNESOTA
IN COURT OF APPEALS

NORTHWESTERN BELL TELEPHONE COMPANY,
Relator,

v.

MINNESOTA PUBLIC UTILITIES COMMISSION,
Respondent.

BRIEF AND STATUTORY APPENDIX OF NORTHWESTERN BELL TELEPHONE COMPANY

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LEGAL ISSUES

I. Did the Minnesota Public Utilities Commission Error in Finding that Northwestern Bell Engaged in Illegal Contacts Which Affected the Commission's 1984 Rate Case Deliberations in Final Rate Order?

The Commission ruled in the negative.

A. Was there any illegal conduct involved in any of Northwestern Bell's contacts with the Commission?

The Commission ruled in the affirmative.

B. Were the contacts "prohibited" ex parte contacts?

The Commission ruled in the affirmative.

C. Was the Commission's Finding as to the "public's perception" of the contacts supported by substantial evidence?

The Commission did not rule on this issue but based its finding on an assumption.

D. Did the contacts illegally affect the 1984 Rate Case Deliberations and Order?

The Commission ruled in the affirmative.

II. Does the Commission Have Statutory or Inherent Authority to Reopen and Vacate a Final Rate Order Which is Over 2¾ Years Old?

The Commission Ruled in the Affirmative with respect to inherent authority but did not discuss statutory authority.

III. Does the Minnesota Supreme Court's Decision in Henry v. MPUC That Northwestern Bell's Docket 600 Rates are Just and Reasonable Bar the Commission's Action in Docket 177 Under the Doctrine of Res Judicata?

The Commission ruled in the negative.

IV. Is The Commission's Order to Vacate, Reopen and Redeliberate a 2¾ Year Old Final Rate Case Order a Violation of the 10 Month Rule of *Minn. Stat.* 237.075?

The Commission ruled in the negative.

V. Were the Procedures Used By the Commission in Docket 177 a Violation of Northwestern Bell's Constitutional and Statutory Rights?

The Commission ruled in the negative.

STATEMENT OF THE CASE

Northwestern Bell Telephone Company ("Northwestern Bell" or "the Company") is a telephone company within the meaning of *Minn. Stat.* § 237.01, Subd. 2. The Minnesota Public Utilities Commission ("MPUC" or "the Commission") is an administrative agency which has authority pursuant to *Minn. Stat.* Chapter 237 to set Northwestern Bell's rates for intrastate telephone services under certain circumstances and after following certain statutory procedures.

This case ("MPUC Docket 177") is an appeal from an order of the Commission which collaterally reopened and vacated a 2¾ year old final general rate case order.[1]

A. Northwestern Bell's Last Rate Case—Docket 600

Northwestern Bell's current general telephone rates were established in MPUC Docket No. P-421/GR-83-600 — "Docket 600" — pursuant to a petition filed by the Company nearly four years ago on September 29, 1983. The Commission approved interim rates effective November 28, 1983 and after lengthy and complex rate proceeding the Commission issued a 100 page determination establishing rates on July 27, 1984 ("the 1984 Rate Order.")

The Commission's 1984 Rate Order was appealed, and in *Henry v. Minnesota Public Utilities Commission*, 392 N.W.2d 209 (Minn. 1986) the Minnesota Supreme Court held, among other things, that the rates established by the 1984 Rate Order were just and reasonable and supported by substantial evidence on the record. (*Henry, supra,* pp. 215-216). Thus, Northwestern Bell's current general telephone rates were established by a final order of the Commission which, prior to the issuance of the orders here in question, have been in effect for over 2¾ years.

B. The "Summary" Investigation — Docket 177.

On April 9, 1986 the Commission, in a separate docket — MPUC Docket No. U-999/CI-86-177 (hereinafter "Docket 177") — issued an order initiating a "summary" investiga-

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[1] If the Commission's action is not overturned, amounts up to or in excess of $40 million which have already been collected by the Company and expended on operational expenses, maintenance of service, capital improvements and dividends may be subject to unconstitutional confiscation. In addition, until corrected in future rate proceeding up to $11.9 million per year in future rates may be subject to unconstitutional confiscation. (MPUC Order, April 3, 1987, Docket 600.)

tion. (A - 1). The Commission's Docket 177 order noted the existence of various newspaper reports and governmental investigations relating to contacts alleged to have occurred between former Commissioners and various utilities, and stated the Commission believed it necessary to investigate whether any prior Commission decisions may have been adversely affected by improper contacts.[2]

The Commission, therefore, directed the Minnesota Department of Public Service ("DPS") to continue an investigation regarding these contacts which the DPS had begun two months earlier and also to conduct an investigation on behalf of the Commissions. (A - 2-3). On July 8, 1986 the DPS completed its investigation and issued a report summarizing the result of its summary investigation ("DPS Report"). (A - 4). Attached to the DPS Report were 7 depositions taken by the DPS during its investigation and 91 "exhibits" which were collected by or created by the DPS investigators.

The DPS Report made a number of findings and recommendations related to other parties and other dockets in addition to Docket 600 not relevant here. With respect to Docket 600, however, the DPS Report concluded that:

—During the 14-months that Docket 600 was pending before the Commission, a representative of the Company had

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[2] NWB has voluntarily assisted all said governmental investigations and has not been found to have violated any law by any of said governmental investigations, including the FBI and Ramsey County Attorney's investigations, referred to in the order. (NWB Petition for Reconsideration and Vacation, April 15, 1987, p. 2). Furthermore, a Federal judge has granted NWB a *complete dismissal* of a private federal civil suit brought in connection with some of the same allegations. *H. J. Inc. v. Northwestern Bell Telephone Company*, 648 F. Supp. 419 (D. C. Minn. 1986); and a state district judge has granted NWB a *complete dismissal* of a similar private state civil suit, *H. J., Inc. v. Northwestern Bell Telephone Company*, Minnesota Dist. Ct., Fourth Judicial Dist., File No. 86-24166, Judgment Docket, June 22, 1987.

a number of meetings with Commissioners in restaurants involving meals paid by the Company. (DPS Report, pp. 59, 64-65, A - 66, 71-72).

—The two Commissioners and the Company representative who participated in these meals all testified under oath that at no time did these meetings involve discussions of Docket 600 issues. (DPS Report, pp. 58-59, Depositions of Weir, Adams and Hanson, A - 65-66).

—During the period Docket 600 was pending there was no statute or rule in effect in Minnesota which prohibited a regulated Company from paying for meals consumed at meetings attended by Commissioners. (DPS Report, pp. 59-63, A - 66-70).

—It is unlikely that Commissioners could be bribed with free lunches or dinners. (DPS Report, pp. 58, A - 65).

—During the period Docket 600 was pending there was no statute or rule in effect which prohibited ex parte discussions between representatives of regulated companies and Commissioners. (DPS Report, pp. 66, A - 73).

The DPS Report contained no evidence or conclusion that any particular vote of the Commission in Docket 600 had been influenced either by the purchase of meals or by any discussions which occurred during the meals. The DPS Report did not recommend reopening or reconsideration of the 1984 Docket 600 Rate Order.

Upon receipt of this report the MPUC solicited comments from Northwestern Bell and other interested parties. (A - 89). Northwestern Bell gave written notice to the Commission and all parties that Northwestern Bell would object to any action taken by the Commission, based on the so called "evidence" created by the DPS under the "summary" investigative procedures utilized in Docket 177, to reopen or reconsider

the 1984 Docket 600 Rate Order. (NWB's Comments Regarding the MPUC's October 3, 1986 Order, dated October 22, 1986, pp. 16-17; A - 98-99).

C. The Petitions for Reconsideration or Dismissal of the Docket 600 Rate Order.

In July 1986 the Residential Utilities Division of the Office of Attorney General for the State of Minnesota ("AG-RUD" or "the Attorney General") filed a petition with the Commission requesting the Commission to reopen and reconsider the 1984 Rate Order in Docket 600 alleging that the Company had engaged in improper ex parte contacts regarding the Commission's rate case deliberations. (A - 100). The AG-RUD's petition was entirely based upon the DPS Report and the AG-RUD filed no evidence itself in support of its petition. The AG-RUD admitted in its petition that it had no knowledge of the specific content of any of the discussions which occurred between the Company representative and the Commissioners which were alleged to be improper. (AG-RUD Petition, July 9, 1986, p. 5, A - 105).

On August 14, 1986, the Minnesota Public Interest Research Group ("MPIRG") filed a petition with the Commission also based upon the DPS Report requesting the Commission to vacate and dismiss the 1984 Rate Order as well as the Commission's November 13, 1984 Order in Docket 600 relating to intervenor compensation. MPIRG filed no evidence in support of its petition. MPIRG also admitted in its petition that it had no knowledge of the contents of any alleged ex parte discussions. (MPIRG Petition, August 14, 1986, p. 9).

On October 22, 1986 the DPS filed comments with the Commission altering the DPS's earlier position and recommending that the Commission redeliberate the 1984 Rate Order in Docket 600. (Comments of DPS, October 22, 1986, p. 2).

Northwestern Bell filed responses to the Petitions of the AG-RUD and MPIRG and the DPS Comments which, in summarized form, asserted:

—The contacts about which the DPS, AG-RUD and MPIRG complain were not illegal.

—The contacts about which the DPS, AG-RUD and MPIRG complain were not prohibited "ex parte" contacts.

—The contacts about which the DPS, AG-RUD and MPIRG complain did not affect Docket 600.

—Under the circumstances of the "summary nature" of the proceedings in Docket 177, the MPUC has no legal authority to reopen, reconsider or dismiss the 1984 Rate Order in Docket 600.

—There are other substantial reasons for not reopening Docket 600. (NWB's Reply to Comments of the Other Parties, November 3, 1986; Response of NWB to Petition to Reopen and Reconsider filed by the AG-RUD, July 18, 1986; Response of NWB to Petition of MPIRG; NWB's Response to the AG's Reply Brief, September 15, 1986; Response of NWB to July 8, 1986 Report of the DPS to the MPUC, August 13, 1986).

D. The Commission's Deliberation and Order to Vacate and Reopen the 1984 Rate Order.

On November 7, 1986 the Commission met in Docket 177 and deliberated the AG-RUD and MPIRG petitions regarding the 1984 Rate Order in Docket 600. The Commission had not referred the matter to a contested case hearing and had no evidence before it except the disputed "evidence" created over Northwestern Bell's objection in the DPS summary investigation.

The Commission voted not to reopen any of the dockets recommended by the DPS in its original report. The Commission also voted to deny MPIRG's Petition to dismiss the Com-

mission's July 27, 1984 and November 13, 1984 Orders in Docket 600. The Commission did however vote to approve the AG-RUD's Petition to reconsider the 1984 Rate Order in Docket 600. (A - 107-108).

During the Commission's November 7, 1986 deliberations and vote to reopen and reconsider Rate Case Docket 600, no Commissioner indicated he or she was aware of any evidence, in the DPS Report or otherwise, that any particular vote in Docket 600 had in fact been influenced by any contact between any Commissioner and any representative of Northwestern Bell. (MPUC tape #86-166 (partial), tape #86-167, tape #86-168, tape #86-169, and tape #86-170 (partial)). During said deliberations several of the Commissioners commented that they had no knowledge as to what was discussed at any of the meal meetings which occurred between the Company's representative and former Commissioners Adams and Hanson and had no knowledge that any particular vote was influenced by the contacts. (MPUC tape #86-166 (partial), #86-167, tape #86-168, tape #86-169 and tape #86-170 (partial)).

Between February 12 - 19, 1987 the Commission met in Docket 600 and redeliberated on all the issues involved therein. At no time during the redeliberations and votes did any Commissioner state that the rates which had been previously established in Docket 600 were unjust or unreasonable. (MPUC tapes #87-36 through #87-65). The Commission voted, however, to change a number of the decisions which had been made in Docket 600 several years earlier. Those changes, if put into effect, would result in lowering the Company's annual revenue requirement by $11.9 million.[3]

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[3] The redeliberations and votes in Docket 600 and the MPUC's resulting orders of April 3, 1987 and June 4, 1987 in Docket 600 are the subject of a separate appeal to this court in *NWB Tel. Co. v. MPUC*, C9-87-1257.

On April 2, 1987 the Commission issued its final order in Docket 177 vacating the July 27, 1984 Rate Order in Docket 600. (A - 109). Northwestern Bell's Motion for Reconsideration was denied upon June 4, 1987. (A - 131). Northwestern Bell obtained a Writ of Certiorari to review said April 2, 1987 order and said June 4, 1987 order in this appeal.

In the event Northwestern Bell is successful in this appeal in reversing those orders in Docket 177, the 1984 Rate Order would be reinstated and Northwestern Bell's appeal in Docket 600, C9-87-1257, would be moot.

STATEMENT OF FACTS

As a "telephone company" within the meaning of *Minn. Stat.* § 237.01, Subd. 2 (1984) many of Northwestern Bell's intrastate business activities are subject to regulation by the Minnesota Public Utilities Commission pursuant to various provisions of Chapter 237 and Chapter 216A of the Minnesota Statutes. For example, the Commission has jurisdiction to determine appropriate changes in the general rates which the Company charges for its Minnesota intrastate telephone services. *Minn. Stat.* § 237.075.

Ratemaking, however, is not the only activity which brings Northwestern Bell into contact with the MPUC. (Wier Dep. 25-26). As defined by *Minn. Stat.* § 216A.02 the MPUC engages in some functions which are "legislative" in nature, some which are "administrative" in nature, and some which are "quasi-judicial" in nature.

An example of a legislative function would be the promulgation of rules having general applicability to all telephone utilities such as MN Rule 7845.0100, et seq. (A - 138). An example of an administrative function would be the issuance of policy statements, not amounting to formal rulemaking, regarding such matters as scheduling or staffing. Also, from

time to time the Commission meets informally with groups such as Senior citizens, the handicapped or investment analysts for general background information purposes. (Hanson Depo. 12). An example of a quasi-judicial function would be resolving disputed issues resulting from a contested case having particular applicability to the conduct of a particular regulated entity. Some of the issues in a ratemaking case such as Docket 600 fall into the quasi-judicial category.

In addition, the MPUC engages in other activities which can have an affect on the telephone industry in general and Northwestern Bell as one of its members. For example, from time to time the Company or Commission takes positions on issues before the state legislature as to changes in the law or additions to the law applicable to the telephone industry. (Weir Dep. 16-17). Commissioners and staff members would sometimes seek information regarding such legislative concerns from Northwestern Bell. (Madison Dep. 54-56).

During any given year there are hundreds if not thousands of topics of information which are of mutual interest to telephone companies such as Northwestern Bell and the MPUC. Some relate to particular pending matters but most relate to general background information. Furthermore, many fall into the legislative or administrative functions of the Commission and fewer fall into its quasi-judicial function. (Hanson Dep. 11-14).

In order to facilitate the transfer of information between Northwestern Bell on the one hand and the state legislature or the Minnesota Public Utilities Commission on the other, the Company has utilized its Government Relations/Regulatory Department. During 1984 and for eight years prior thereto Roy Weir was the head of that department. (Weir Dep. 21-23). There was a small group of employees, who had primary responsibility for issues and concerns related to the

state legislature who reported to Mr. Weir. There was a larger group of employees, who were primarily responsible for assisting Mr. Weir in preparing and providing information to the Commission and its staff and receiving information therefrom in connection with Regulatory matters. The total staff was about 32 or 33. (Weir Dep. 23-24). In addition the Company's Legal Department would coordinate its activities with the Regulatory Department in providing information to the Commission of a legal nature. (Weir Depo. 24-25).

1984 was an extremely eventful year in the corporate life at Northwestern Bell. It was the first year following the breakup of AT&T on January 1, 1984 it was the first year Northwestern Bell operated under the ownership of the newly created U.S. West, Inc. It was the first year that a number of U.S. West subsidiaries were created and began working out relationships with Northwestern Bell.

Similarly, state regulatory activities are significantly affected by regulation at the Federal level by the Federal Communication Commission ("FCC") and by the decisions of U.S. District Court Judge Harold Greene who presided over the AT&T breakup. It is important for the Commission to know how the Company views the effects of Federal regulation on its Minnesota operations.

During 1984 there was a veritable explosion of information related to the telecommunications industry in general and Northwestern Bell in particular completely unrelated to Docket 600. Some of it was related to technology, some was related to business concerns and some to state and regulatory issues. Most of this information had nothing whatsoever to do with particular pending quasi-judicial contested case issues such as Docket 600.

During 1984, however, the Commission did consider and decided the extent to which Northwestern Bell's request for

an increase in rates would be granted in Docket 600 which had been filed in September 1983.

In Docket 600 Northwestern Bell introduced testimony, exhibits and economic arguments through the normal contested case hearing process pursuant to *Minn. Stat.* § 237.075 and *Minn. Stat.* § 14.01, *et seq.* The Company argued in favor of and believed it proved to the Commission that its general rates should be increased to approximately $107 million a year (its original application for $109 million was lowered during the hearing process) and that its authorized rate of return should be set at approximately 16.5%. The Commission's decision in Docket 600 was issued July 27, 1984 to the following effect:

—The Commission voted to slash approximately $50 million from the amount of the revenue increase NWB requested resulting in a $57.5 million increase.

—The Commission voted to lower the Company's requested authorized rate of return from 16.5% to 14.5%.

—The Commission voted to order Northwestern Bell's transfer of its Yellow Pages business to U.S. West Direct to be null and void.

—The Commission also determined dozens of other issues many of which were against Northwestern Bell's positions. (MPUC Minutes re: Docket 600 Proceedings.)

During 1983, 1984, and 1985 Mr. Weir had a number of personal contacts with Commission members. As head of the Company's Regulatory activities Mr. Weir's signature appeared on cover letters and correspondence which passed thousands of pages of documents to the Commission and its staff on a variety of subjects. (Weir Depo. p. 25-27, also see MPUC correspondence files.) Some were related to Docket 600, most were not. Mr. Weir also had a number of meetings

with Commissioners in their offices as well as at other public locations such as restaurants. (Hanson Depo. 45-46, Adams Depo. 23-24). Some of these occurred on or near days the Commission was discussing Docket 600, but the vast majority did not.

While Docket 600 was technically "pending" from the time it was filed in September 1983 until it was finally concluded in October 1984, there were only two dozen days out of that 14 month (420 day) period on which any Commission activity occurred regarding Docket 600. (MPUC Order April 12, 1986, pp. 6-9, MPUC Minutes, September 1983 - October 1984). On 15 of these 420 days the MPUC's order selectively links, by time only, a date on which some Docket 600 activity occurred within three days (day before, day of, or day after) a meal occurring between Weir and one or more Commissioners. (MPUC April 2, 1987 Order, pp.6-9). At no time does the MPUC order find that any specific discussion occurred at any of the meal meetings regarding Docket 600.

The MPUC order fails to mention that the DPS Report also produced "evidence" that during the 24 month period from May 1983 through April 1985, ten of which involved no Docket 600 activity, there were a total of approximately 125 meal meeting attended by Weir and one or more Commissioner. (DPS Report, Exh. 17, Doc. "6," Exh. 18, Doc. "E" and Doc. "F," Exh. 23, Doc. "K", Adams Depo. Exh. 4 and Madison Depo. Exh. 3). Again, only 15 of these 125 meal meetings were within three days (day before, day of, day after) some MPUC rate case activity. One hundred ten were not. (See Exhibits and Minutes referred to in this and prior paragraph).

According to the depositions of Mr. Weir and Commissioners Hanson and Adams taken by the Department of Public

Services, Mr. Weir and both Commissioners had extremely busy schedules and they found it convenient to combine some of their discussions with meal time. These meals were paid for by Weir for which he was reimbursed by the Company. According to Company expense records Mr. Weir met more frequently with Commissioners Adams and Hanson but he also had at least some similar meetings with the other Commissioners.

Weir, Hanson and Adams have all testified under oath, however, that at no time at any of these meetings did they discuss the issues pending in Docket 600. (MPUC April 2, 1986 Order, p. 9 and DPS Report, p. 64). Furthermore, Hanson and Adams testified that neither was influenced in any way by the fact that the meals were provided at Company expense. (Adams Depo. 93-94, Hanson Depo. 53-57). Finally, Weir testified that he did not intend to influence the decision of the Commissioners Hanson and Adams regarding Docket 600 by the conduct of these meetings. (Weir Depo. 224-243, 257-261).

Furthermore, all three deponents testified that topics which were discussed at these meetings were legitimate topics. For example, both Hanson and Adams testified that they were former members of the state legislature. They testified that they first became acquainted with Mr. Weir while he was acting as a lobbyist on behalf of Northwestern Bell regarding the state legislature. (Hanson Depo. 10, 39-40; Adams Depo. 8). Thus, they were familiar with the practice of legislators meeting with lobbyists for lunch. They were also comfortable in meeting Weir because they had come to know him well. Both Hanson and Adams testified, however, that they knew their role as MPUC members was different than that as legislators, and thus avoided some topics of discussion, such as

contested rate case issues. (Hanson Depo. 22-24, 54; Adams Depo. 13-15, 25.)

During his deposition Hanson also was asked to explain why the meetings between Hanson and Adams were more frequent than other Commissioners. (Hanson Depo. 44). Hanson testified that since Adams and Hanson were former legislators, and since Weir had first met them in that capacity, "the three of us shared a common history." Their joint interest in that history and the politics associated with it formed the basis of many of their discussions. (Hanson Depo., p. 45). Hanson also testified that 1984 was the last year of his term on the Commission. Hanson testified that during 1984 he was approached regarding a vacant seat on the Minnesota House of Representatives and sought Weir's opinion regarding that subject because he valued Weir's legislative experience and political advice (Hanson Depo., p. 48). Hanson also testified that during 1984 there was general speculation that the senate seat formally occupied by Hanson might come up for election on short notice because the plans of the incumbent to seek another office. Hanson testified that he consulted with Weir regarding that subject. (Hanson Depo., 49-50). Hanson testified that he sought Weir's advice on whether it was worthwhile for him to seek reappointment to the Commission given the fact that Hanson was a member of the opposite political party from the Governor who would be making the appointment. (Hanson Depo., p. 50).

Hanson also testified that during this period one or both of Weir's parents died and Weir also was troubled from time to time regarding the serious illness of his granddaughter. Hanson testified that, "I have lost my mother and father and our families being the same age, although the families are not socializing together, we would talk at length about that."

(Hanson Depo., p. 50). Hanson testified that he believed during the same period he wrote an extensive "position paper" on the subject of "ameliorated rates." This in-depth position paper was on an issue not before the Commission at the time. Hanson testified he valued Weir's technical advice and political advice regarding this subject. (Hanson Depo., p. 51).

Hanson was specifically asked under oath whether he believed his personal relationship with Weir in anyway affected Hanson's view of issues pending before the Commission. Hanson replied as follows:

> . . . I realized that the process of making decisions in regulatory arena is a result of receiving expert testimony, receiving record evidence, and making a determination strictly on what the Commission has before it irrespective of who your friends are and even who your enemies are.
>
> I would say this is more, I would say some people can't understand this and I realize that. But is more a carryover from the legislative experience where it is not uncommon at all and I have experienced it myself, where you are in a position to make very important decisions quite often against your friends, quite often against the people, your roommate, quite often against the people in the political party and everybody in the legislative process understands very well that your votes have nothing to do with who you know well or how well you know a person.
>
> They are strictly based on the merits before us. (Hanson Depo., p. 54).

Weir also gave testimony concerning the legitimate topics of conversation which occurred during such meetings. Weir

testified that he made himself available to Commissioners so that if Commissioners saw problems with the way the Commission was operating they could bring it to his attention. Weir also testified that he made himself available to Commissioners at such meetings to clear up any rumors or hearsay they might have heard about the Company or to clarify any stories in the news media. (Weir Depo., p. 55).

Weir was a registered lobbyist under *Minn. Stat.* § 10A.01 et seq. (Lobbyist Reg. No. 5-0185-0673—DPS Report, Exh. 11). Weir filed quarterly disclosure forms with the Government Ethics Practices Board which disclosed the quarterly amount he spent on entertainment and food and beverages in connection with legislative or administrative lobbying. (DPS Report, Exh. 11, Weir Depo. 268).

Both Hanson and Adams testified that they had more discussions with policy advocates of the Department of Public Service, one of the other parties in Docket 600, than they did with Weir and that the nature and extent of their discussions of regulatory matters with Weir was not substantially different from that with the Department of Public Services representatives. (Hanson Depo. 157-160; Adams 95-96). No witness testified that any of the contacts involving Weir and the Commissioners at which meals were purchased involved discussions of Docket 600 issues.

ARGUMENT

I. THE COMMISSION ERRED IN FINDING THAT NORTHWESTERN BELL ENGAGED IN ILLEGAL CONTACTS WHICH AFFECTED THE COMMISSION'S 1984 RATE CASE DELIBERATIONS AND FINAL RATE ORDER.

The Commission's April 2, 1987 order in Docket 177 which vacated the 1984 Rate Order in Docket 600 purports to be

based upon certain contacts which occurred between a Company representative, Mr. Weir, and former Commissioners Adams and Hanson during the 14-month period between September 2, 1983 and October 23, 1984 while Docket 600 was pending. (MPUC April 2, 1987 Order, p. 10). The Commission found these contacts to be a serious abuse and violation of the regulatory process because they were (1) allegedly illegal ex parte contacts relating to the Docket 600 rate case proceeding and (2) because Northwestern Bell paid for the meals involved in these contacts allegedly creating an illegal conflict of interest for the Commissioners. (MPUC April 2, 1987 Order, p. 12).

It is clear, however, even from the summary nature of the DPS investigation and report, that none of these contacts were illegal and none of these contacts had any effect on the 1984 Rate Order. The Commission's conclusions to the contrary are not based upon substantial evidence in the record.

A. There Was No Illegal Conduct Involved in any of Northwestern Bell's Contacts With the Commission.

During the period in question, September 1983 through October 1984, there was no Minnesota statute, rule or regulation in effect which specifically prohibited a representative of a regulated company from paying for meals consumed by members of the Public Utilities Commission while matters involving the regulated company were pending before the Commission. Similarly, during said period there was no Minnesota statute, rule or regulation in effect which specifically prohibited a regulated company from engaging in ex parte contacts with members of the Public Utilities Commission. Furthermore, legislation which was in effect at that time implicitly authorized the contacts which the Commission now finds to be illegal. Finally, legislation and rules which have

been passed long after said contacts occurred unquestionably demonstrate that both the State Legislature and the Commission are aware that the contacts in question did not violate any prior existing law or regulation.

1. Meals as Conflicts of Interest.

The Minnesota Ethics in Government Act, *Minn. Stat.* Chapter 10A (1984), among other things, regulates lobbying activities. It is clear from § 10A.01 of the Act as it existed during the pendency of Docket 600, that lobbying activities in connection with administrative actions, including utility rate determinations, were covered by the Act. The Act, however, *did not prohibit* the purchase of meals in connection with such activities but merely required that lobbyists register and file quarterly disclosure statements in a proscribed format regarding lobbying disbursements. Furthermore, since the proscribed lobbying disbursement form (DPS Report, Exh. 11) had specific line items for disclosing "entertainment" and "food and beverages" for "administrative" lobbying, it is clear that during the period in question Minnesota law authorized registered lobbyists to purchase meals for public officials including members of the Public Utilities Commission. Mr. Weir was a duly registered lobbyist under the Act. (Lobbyist Registration No. 5-0185-0673—DPS Report, Exh. 11). As such Mr. Weir filed quarterly lobbyist disbursement reports with the Minnesota Government Ethics Practices Board on proscribed forms provided him by the state on which he disclosed the quarterly amounts he spent on food and beverages in connection with his administrative lobbying activities. (DPS Report, Exh. 11; Weir Depo. 268).

The Commission's findings, conclusions and order of April 2, 1987 and order denying reconsideration of June 4, 1987 totally ignore the applicability of *Minn. Stat.* Chapter 10A

(1984) to Mr. Weir's contacts in this matter. Furthermore, the Commission's orders totally ignore the finding of the DPS Report that the purchase of said meals was not a violation of law as it existed during the pendency of Docket 600. (DPS Report, pp. 58-62, A-66-70).

Similarly, the Commission's orders totally ignore the only Minnesota Statute which specifically discusses conflicts of interest and members of the Public Utilities Commission. *Minn. Stat.* § 216A.035 (a) (1984), as it existed during the pendency of Docket 600, specifically stated:

> No person during his term of membership on the Public Utilities Commission shall receive any *significant portion of his income* directly or indirectly from any public utility.... (Emphasis added).

Since the law at that time specifically stated that a Commissioner could receive *some* portion of his income from a public utility[4] so long as it was not a *significant* portion of his income, it is clear that the Commission's determination that NWB's purchase of meals for Commissioners Adams and Hanson was an illegal conflict of interest is without merit.

It is also important to note that in March 1986, long after the conduct in this case had occurred, the Minnesota State Legislature changed the law. *Minn. Stat.* § 216A.035 was amended in two relevant respects. First, it now prohibits members of the Public Utilities Commission from receiving any income from any public utility. Second, the 1986 amendments specify that the new prohibitions apply to telephone companies as well as public utilities. Thus, it is clear the state legislature has recognized that the conflict of interest pro-

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[4] *Minn. Stat.* § 216A.035(a) (1984) only applied to gas and electric public utilities in 1984. In 1986 it was amended to apply to telephone companies as well.

visions of the prior statute were not applicable to the present case. For the Commission to attempt to bring Northwestern Bell's 1984 conduct under the reach of a 1986 change in the law, therefore, would be a gross and obvious denial of due process.

2. Meals as Ex Parte Contacts.

In March 1986 the Minnesota State Legislature passed *Minn. Stat.* § 216A.037 which for the first time required the Commission to adopt rules regarding "permissible and impermissible ex parte communications." Prior to the passage of *Minn. Stat.* § 216A.037 in 1986 there was no Minnesota statutory nor regulatory definition of ex parte communications, let alone a prohibition against such communications in MPUC proceedings. The Commission has now adopted rules defining impermissible ex parte contacts. They did not become effective until 1987. (A-137). The legislative activity of the Minnesota State Legislature and the rulemaking activity of the Commission in 1986 and 1987, respectively, clearly underscores the fact that the contacts which occurred between Mr. Weir and Commissioners Hanson and Adams in 1984 were not then illegal. For the Commission to rely on *ex post facto* statutory and regulatory prohibitions to punish conduct which previously was perfectly legal would be a clear violation of due process of law.

B. The Contacts Were Not "Prohibited" Ex Parte Contacts.

The Commission's April 2, 1987 order in Docket 177 wrongfully characterizes the meetings between Mr. Weir and Commissioners Adams and Hanson as illegal ex parte contacts. However, even under the current statute (*Minn. Stat.* § 216A.-037 (1986)) and the new Commission rules (Minn. Rules Parts 78545.7000-78545.7600), which were not in effect dur-

ing 1984, a communication is not an illegal ex parte contact unless it involves communications regarding a "material issue" in a pending contested case proceeding or disputed petition. (A-137).

Thus, the mere fact that a party to a proceeding meets and has discussions with a Commissioner without other parties being present while a contested matter is pending is not a "prohibited" ex parte contact in and of itself. There must be probative evidence on the record that such a meeting also involved the discussion of a "material issue" in the contested proceeding to make the ex parte contact impermissible.

While the Commission's 1987 orders in Docket 177 ignore this "material issue" requirement of prohibited ex parte contacts, prior to the current controversy the Commission's own legal counsel did not. On August 1, 1985 the Special Assistant Attorney General assigned to the Commission issued a legal memorandum which gave the Commission some "guidelines" in answering the question, "what is an ex parte contact?" After providing a formal definition which included such requirements as (a) the communication must be "related to a specific case or docket," and (b) the communication must include, "specific facts relating to a specific utility or telephone" company, the opinion went on to state:

> However, not all contacts with parties or persons interested in a case are ex parte contacts. Inquiries that do *not address the merits of the case* . . . would *not* be considered an ex parte contact."

(Attorney General's Office Memorandum, August 1, 1985 referred to in DPS Report Exh. 69; A-141, emphasis added).

The contacts involving Mr. Weir and Commissioners Adams and Hanson which the Commission's April 2, 1987 order found to be illegal were not such contacts. Former Commis-

sioner Adams testified that at the meetings in question, "[W]e would discuss anything that was *not a contested case* before the Commission." (Adams Depo., pp. 13-14, emphasis added). Similarly, Hanson testified that he and Weir did not discuss "anything that would be even remotely or tangentially related to the 83-600 case." (Hanson Depo., p. 80). Furthermore Hanson testified that Weir did not attempt to influence Hanson's decision on the 600 case "during any of those meals or at any other time." (Hanson Depo., pp. 83-84). Weir also testified that he did not discuss contested case dockets or issues with the Commissioners ex parte. (DPS Report, p. 66, A-73).[5]

Since none of the petitioning parties to this docket have produced any *evidence* which refutes this sworn testimony, there is no evidence in the record which supports the Commission's finding and conclusion that Northwestern Bell engaged in *illegal* ex parte contacts during Docket 600. Thus, those portions of the Commissions orders should be stricken as not based upon substantial evidence in the record and the 1984 Rate Order should be reinstated.

C. The Commission's Finding as to the "Public's Perception" of the Contacts is not Supported by any Evidence in the Record.

In addition to the matters discussed in the previous section, the Commission made a number of other findings regarding Northwestern Bell's conduct during Docket 600 which are not supported by evidence in the record. One of these related to the "public's perception" of the contacts in questions.

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[5] There are many more similar sworn statements from Adams, Hanson and Weir which establish this point which are set forth in the Statement of Facts, *supra*, pages 13-16.

On page 12 of its order the Commission finds that Northwestern Bell's contacts with the Commission in connection with Docket 600 "have created an atmosphere of public distrust and lack of confidence in the regulatory process." On page 4 of its order the Commission states that the Commission is concerned not with whether the original decision in a Docket 600 was correct but with "the public's perception of the process" used in making that decision. There is, however, absolutely *no evidence* in the record as to what the public's perception is of that process or that supports the Commission's finding that Northwestern Bell created an atmosphere of distrust.

During the original Docket 600 proceedings in 1984, a number of public hearings were held in communities all over the state which enabled the public to testify as to their viewpoint on the merits of Northwestern Bell's rate increase application. In addition, during the 1984 Docket 600 evidentiary hearings some of the parties submitted public opinion survey data regarding some of the original issues contested in Docket 600. Thus, with respect to those original issues the Commission, the parties and the Administrative Law Judge felt it important and necessary to provide some evidence in the record as to the public's perception. With respect to the Commission's Docket 177 order to vacate and reopen the 1984 Rate Order, however, there was absolutely no public testimony taken regarding the public's perception of the alleged contacts or their affect on the Docket 600 ratemaking process, nor did any of the parties submit any public opinion survey data regarding said public's perception.

The Commission, nevertheless, based its cataclysmic decision to throw out a 2¾ year old rate order, not on evidence that particular votes or issues were improperly influenced,

but on the Commission's unsupported belief that the public distrusted the process. In fact, in the MPUC's official minutes of its motion and vote the Commission admits it was an "assumption" not a "finding." (A-107). Thus, the Commission's "finding" and conclusion in its Docket 177 order regarding the public's perception of the processes used in conducting Docket 600 not only lacks substantial evidence to support it but it lacks any evidence whatsoever. The Commission's findings, conclusions and order regarding the public's perception of the processes used in Docket 600, therefore, should be stricken.

D. The Contacts did not Affect the 1984 Rate Case Deliberations or Order.

As stated earlier Commissioners Adams and Hanson both gave sworn testimony during the DPS investigation denying that the contacts involving Weir had any affect whatsoever on their decision-making in Docket 600. None of the parties to Docket 177 have offered any *evidence* that any specific vote or decision made in Rate Case Docket 600 was affected by said contacts. In fact, a number of the parties have admitted in their pleadings in Docket 177 that they are not aware of what was discussed during the contacts in question and what effect any such discussions may have had on any particular issue in the case.

The Commission's April 2, 1987 order attempts to substitute disbelief, suspicion and inference for evidence to refute the uncontradicted sworn testimony of record. As noted by the FCC in *Re WORZ, Inc.*, 48 PUR 3rd 56 (1963), however:

> "Sworn denials, while not conclusive of the facts, are not to be brushed aside lightly on the basis of an indefinable 'normal human experience,' . . . *Suspicion, specula-*

tion, and conjecture are not proper substitutes for evidence, and cannot of themselves form the basis for conclusions that an applicant engaged in improper conduct requiring its disqualification and that two or more witnesses testified falsely. . . ." (*Id.*, p. 60-61, emphasis added).

Furthermore, during the deliberations in this matter a number of Commissioners admitted they did not know what Weir may have discussed with Commissioners Adams and Hanson and did not know that any particular vote was influenced in anyway by such contacts. (MPUC tape recordings #86-166 through #86-170). In fact, in its April 2, 1987 order the Commission specifically found that, ". . . it is difficult to accurately assess the effect NWB's actions had on particular votes on particular issues." (April 2, 1987 Order, p. 10).

It is also apparent from the original decision in Docket 600, however, and the Commission's later analysis of that decision that it was not improperly influenced in any way by the contacts in question. During the 1984 original Docket 600 proceeding, Northwestern Bell had requested and believed it had proved to be entitled to a rate increase in excess of $107 million. The Commission, however, voted to cut that request by approximately $50 million. The Company originally requested and believed it proved to be entitled to an authorized rate of return of 16.5%. The Commission, however, voted to cut that request to 14.5% (which also was lower than the then existing actual authorized return of 14.9%).

Two years later on August 21, 1986 the Commission received a report jointly prepared by the Commission staff and the DPS staff. (A-146). The Joint Staff Report analyzed the financial operations of the company for 1985, the first full year Northwestern Bell operated under the rates set by the 1984 Rate Order, and made the following conclusions:

—Based on 1985 economic data the Commission in 1984 had set the Company's authorized rate of return (14.5%) too low. It should have been set at 15.25%.

—The rates set by the Commission's 1984 Rate Order were also too low to allow the Company to earn either its authorized rate of return (14.5%) or the rate of return which should have been required (15.25%).

Thus it is clear that Weir's contacts with Commissioners Adams and Hanson in 1984 did not have a pro Company affect on the 1984 Rate Order. Otherwise, the Joint Staff Report would have found the Company's authorized rate of return and rates to be too high, not too low.

Since there is absolutely no evidence in the record that any of the alleged improper contacts had any affect on any decision made in Docket 600, there is no factual basis upon which the Commission can support its order to vacate and reopen the 1984 Rate Order due to tainted affect. All Commission decisions must be based upon substantial evidence in the record. *State v. Tri-State Tel. & Tel. Co.*, 204 Minn. 516, 284 N.W. 294, 300 (1939).

II. THE COMMISSION HAS NO STATUTORY OR INHERENT AUTHORITY TO REOPEN AND VACATE A FINAL RATE CASE ORDER WHICH IS OVER 2¾ YEARS OLD.

A. There is No Statutory Authority.

The Commission's sole authority for determining rates regarding Northwestern Bell comes from Minnesota Statutes, Chapter 237. There is no provision in that Chapter which authorizes the Commission to reopen and reconsider a telephone rate order once it has become final—let alone one that has been final for over 2¾ years.

Minn. Stat. § 237.075, Subd. 5 states that once the Commission has issued an order fixing the rates of a telephone

company and has served that order on the telephone company —all of which happened in this case in 1984—"the rates shall thereafter be observed until changed, *as provided by this Chapter.*" (Emphasis added.) Since the State Legislature has not provided the Commission authority under Chapter 237 to change a final rate order established pursuant to Chapter 237 other than by following the procedures set forth therein, the Commission does not have express statutory authority to reopen and vacate the 1984 Rate Order.

The MPUC is a creation of the State Legislature and its jurisdiction and authority are strictly limited as provided by statute. As noted by the Minnesota Supreme Court in *Great Northern Railway Co. v. Public Service Commission,* 284 Minn. 217, 220, 169 N.W.2d 732, 735 (Minn. 1969):

> It is elementary that the Commission, being a creature of statute, has only those powers given to it by the legislature. *Backus-Brooks Co. v. N. P. Ry. Co.,* (8th Cir.) 21 F.2d 4, 19, where the court said: It is well settled the powers of a state Commission are special and limited, and they can exercise only such authority as is legally conferred by express provisions of law, where such as is by fair implication and intendment incident to and included in the authority expressly conferred for the purpose of carrying out and accomplishing the objects for which the Commission was created, and that *any reasonable doubt of existence of any particular power in the Commission should be resolved against the exercise of such power.* (Emphasis added).

The Minnesota Supreme Court in recent years has continued to insist that the Commission live by this doctrine of limited express authority. *Peoples Natural Gas Co. v. Minnesota Public Utilities Commission,* 369 N.W.2d 530, 534 (Minn.

1985) and *Senior Citizens Coalition of Northern Minnesota v. Minnesota Public Utilities Commission*, 355 N.W.2d 295, 303-304 (Minn. 1985).

Furthermore, it is clear that the State Legislature knows how to grant the Commission the authority to reopen final rate orders if it feels that power is appropriate. In *Minn. Stat.* § 216B.25 (1986), the State Legislature explicitly gave the Public Utilities Commission authority in rate cases involving *gas and electric utilities* to reopen and rescind prior orders at any time. That statute, however, as well as the rest of Chapter 216B is specifically *inapplicable* to *telephone* rate determination cases. (*Minn. Stat.* § 216B.02, Subd. 4). While there are many provisions of Chapter 216B (the gas and electric statute) which are similar to Chapter 237 (the telephone regulatory statute), there is no provision in Chapter 237 remotely similar to the power to reopen and amend prior gas and electric orders as set forth in § 216B.25. Thus it is clear the legislature has never given, nor intended to give, the Public Utilities Commission the power to reopen a final telephone rate order such as the 1984 Rate Order.

This is especially clear from action taken by the State Legislature during its most recent session. During its 1987 session, the legislature had before it a bill, S.F. No. 1193 (A-177). Section 3 of S.F. No. 1193 proposed to amend Chapter 237 by adding a new provision to the telephone statute which would have given the Commission authority similar to the authority the Commission has to reopen and amend prior orders as set forth in the gas and electric statute, § 216B.25. The legislature, however, refused to adopt S.F. 1193 and give the Commission that authority. This court has relied on similar actions by the State Legislature in other cases as an indication of a legislative intent not to expand MPUC

authority by implication. *Application of Northwestern Bell Tel. Co.*, 367 N.W.2d 655, 661 (Minn. App. 1985).

The Commission's Docket 177 order to vacate and reopen the 1984 final rate order was, therefore, a clear abuse of its statutory authority.

B. The Authority Relied Upon by the Commission Regarding its "Inherent" Authority is not Controlling in this Case.

The Commission's April 2, 1987 Order contains a discussion of its authority to reopen and vacate the 1984 Rate Case Order. (April 2, 1987 Order, pp. 4-6, A-112). At the outset Commission, in effect, acknowledges it has no express statutory authority by its complete failure to cite any. Instead, the Commission begins by citing *State on State ex rel. Turnbladh v. District Court*, 259 Minn. 228, 107 N.W.2d 307 (1960) and *Anchor Cas. Co. v. Bongard's Coop. Creamery Ass'n.*, 253 Minn. 101, 91 N.W.2d 122 (1958). In doing so the Commission acknowledges that these cases are among those which stand for the proposition that, ". . . courts have expressed a strong disinclination to reopening orders and judgments after a reasonable time." (April 2, 1987 Order, p. 4). The Commission also acknowledges these two cases as holdings which prohibit state agencies, such as the MPUC, from reopening prior orders after agency jurisdiction is lost by appeal or lapse of time for appeal. Faced with the reality that the Commission in the present case had lost such jurisdiction due to the passage of time,[6] the Commission's order vainly attempted to distinguish *Turnbladh* and *Anchor Cas. Co.* rather than be bound by them.

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[6] The time for appeal of the 1984 Rate Order lapsed 30 days after the final order was issued or from the determination of any motion for reconsideration. *Minn. Stat.* § 14.63, § 14.64, § 237.25, and § 237.26.

The Commission's order asserts that these two cases only limit the authority of the Commission to correct erroneous decisions and that in the present case the Commission is not concerned with correcting an *erroneous* decision, "but with the integrity of the decision-making process itself, and the public's perception of the process." (April 2, 1987 Order, p. 4). This attempt by the Commission to create a meaningful distinction, however, fails for a number of reasons.

First, neither *Turnbladh* nor *Anchor Cas. Co.* make such a distinction. Thus, they cannot be relied upon as authority. Second, even if such a distinction were recognized by law in Minnesota, as indicated earlier there is no evidence on the record in this docket establishing what the public's perception is of the process. Third, the Commission cites no Minnesota decision or decision from another jurisdiction which states that a Minnesota administrative agency has "inherent" authority to do anything, let alone, to reopen a final administrative decision which is 2¾ years old. Nor does the Commission cite any authority allowing it to base such a decision on "public perception." Finally, the Commission's order completely ignores the only decision of a Minnesota court which is on point. In *Hough Transit Ltd. v. Harig*, 373 N.W.2d 327 (Minn. App. 1985) this court held that the decision of a Minnesota administrative agency (the Department of Economic Security) is res judicata with respect to a later attempt by the same agency to change it. In doing so this court stated that even if the agency had the power to reverse its earlier adjudication:

> . . . the second decision would be unlawful because not made within a reasonable time. The second representative's decision was made almost *two years after* the first representative's decision. (*Id.*, p. 332, fn. 1, emphasis added).

Since this court has held that the passage of less than two years would preclude the reopening of a final administrative order, the Commission in the present case was clearly without authority to reconsider and vacate its 2¾ year old order.

The Commission's order, however, goes on to cite decisions from several foreign jurisdictions and one Minnesota decision in its attempt to formulate its argument that the Commission has "inherent power" to remedy matter whenever it feels its regulatory process has been abused. Again, the Commission's citation of authority is faulty for a number of reasons. First, the Commission cites no authority which specifically states that state administrative agencies, in general, or Minnesota administrative agencies, in particular, have the "inherent power" to do anything let alone reopen a final rate case order which is over 2¾ years old. Second, the Commission's position regarding "inherent" authority is totally inconsistent with the limited express power doctrine discussed earlier in this brief. (II. A. pp. 27-30). Third, the Commission only cites one Minnesota case for this proposition which, simply put, does not apply.

Halloran v. Blue & White Liberty Cab Co., 253 Minn. 436, 92 N.W.2d 794 (1958), cited by the Commission, did not even involve an administrative agency, thus, it could not have involved the inherent power of an administrative agency. It involved the power of a *court* to reopen a prior court order. *Halloran* held that if one party to a lawsuit conducted in a state district court can prove that another party obtained a judgment by committing intentional fraud on the court, that court may vacate and modify the judgment. In doing so, however, the *Halloran* court noted that the moving party was basing its allegation of fraud on conduct which specifically involved Canon 30 of the Canons of Professional Ethics of

the bar association. The present situation is distinguishable from *Halloran* in that (a) there is no allegation that Northwestern Bell engaged in conduct which violated a specific statute, rule or regulation, and (b) Minnesota administrative agencies do not have the same powers as Minnesota state district courts.

Rule 60 of the Minnesota Rules of Civil Procedure specifically empowers Minnesota state district courts to reopen judgments obtained by fraud under certain circumstances. There is no similar grant of authority to the MPUC. In fact, the Minnesota Supreme Court has specifically held that the granting of rate determining authority to a Minnesota administrative agency is not the same as the granting of judicial powers. *State ex rel Halton v. Four Lakes Tel. Co.*, 141 Minn. 124, 169 N.W. 480 (1918). Thus, *Halloran* does not support the Commission's claim of "inherent" administrative agency power.

In addition, the Commission's April 2, 1987 order also relies on a number of decisions from non Minnesota jurisdictions which are equally inapplicable here. They all involve enabling authority and statutory schemes significantly different than that governing the MPUC.

Universal Oil Products Co. v. Root Refining Co., 328 U.S. 575, 66 S. Ct. 1176, 90 L. Ed. 1447 (1946), cited by the Commission, involved a party to an appeal before a federal appellate court who allegedly bribed one of the appellate justices with over $30,000 and obtained a favorable decision.[7] While dicta in the Supreme Court's opinion states that "a federal court" has the "inherent power" to "investigate whether a judgment was obtained by fraud," the court went

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[7] Facts from decision below, *Root Refining Co. v. Universal Oil Products Co.*, 169 F.2d 514 (3rd Cir. 1948).

on to hold merely that the attorneys involved in the case who acted as amici to the court in the investigation were not entitled to obtain attorney's fees from the losing party. The Supreme Court did not state anything about the "inherent power" of a state agency to reopen a prior decision. Furthermore, the Supreme Court specifically stated that even though a federal court has the inherent power to conduct an investigation, that if the rights of the party who obtained the prior judgment are to be adjudicated based upon the investigation "the usual safeguards of adversary proceedings must be observed." (Id., 328 U.S. at 580, 66 S. Ct. at 1179). Furthermore, the court went on to state, ". . . obviously, a court cannot deprive a successful party of his judgment without a proper hearing." (Id., 328 U.S. at 580, 66 S. Ct. at 1179). Thus, *Universal Oil* does not provide the MPUC with the authority it seeks in this case, nor does it approve the "summary" nature of the procedures used by the MPUC to vacate the prior order in this case.

Hazel-Atlas Co. v. Hartford-Empire Co., 322 U.S. 238 (1944), also relied upon by the Commission, was overruled in some respects later by the Supreme Court in *Standard Oil Co. v. California*, 429 U.S. 17 (1976). Even the original ruling in Hazel-Atlas, however, did not discuss the authority of a state agency. In Hazel-Atlas the Supreme Court held that when a circuit court of appeals makes a finding based on undisputed evidence that a party to an appeal had submitted a forged document to the court and paid a witness $8,000 to commit perjury in connection with the authenticity of the document, the court has the authority under its powers of equity to "devitalize" the prior judgment. Minnesota state agencies do not have the powers of equity that federal courts have and *Hazel-Atlas* does not say that they do.

WKAT, Inc. v. FCC, 296 F.2d 375 (1961) also did not involve the inherent power of a state commission. It involved the power of a U. S. Circuit Court of Appeals under a section of the Administrative Procedure Act, 5 U.S.C. § 1037 (c), to issue an order based upon a recommendation from the FCC. The issue involved in WKAT was who, among competing licensed applicants, was ertitled to a license to provide broadcast services to the public. The moral character of applicants was one of the issues the FCC was required by law to judge in making its decision. This is clear from the FCC opinion which stated:

> . . . the misconduct of [the applicants] reflects so adversely upon their character as to demonstrate that they lack the qualifications to operate the station sought in this application. . . (296 F.2d at 382).

It is also important to note that the FCC did not make its findings of misconduct on behalf of the applicants in *WKAT* based on a "summary" investigation. It appointed a hearing officer who conducted extensive hearings, who made findings, conclusions and an initial decision followed by exceptions being filed by the parties and a hearing and opinion by the FCC under the Administrative Procedures Act. The MPUC in the present case acted under different enabling authority and utilized summary procedures which ignored the requirements of the Minnesota Administrative Procedures Act.

Finally, *State ex rel. Corbin v. Arizona Corporation Commission,* 143 Ariz. 219, 693 P. 2d 363 (1984), cited by the Commission's order, is no more controlling than the others. First, the Corbin case is a decision under Arizona law, not Minnesota law. The Arizona Corporation Commission is created by the Arizona constitution rather than by the Arizona state legislature. Thus, while the Minnesota Public Utilities

Commission has been held only to have specific powers delegated to it by the state legislature, the Arizona Corporation Commission has powers in addition to those granted it by its state legislature. Second, in Corbin the regulatory commission acted prior to the issuance of a final order during a proceeding in which it learned that the attorney for an electrical utility and the director of the Commission's Utilities Division *admitted* engaging in a material ex parte contact with the administrative law judge—they drafted his proposed decision for him. In the present case the Commission acted over two years after the rate was final and had no evidence before it that any decision in question was actually affected by any ex parte contacts. Third, the *Corbin* court held that even under circumstances involved it was not required to dismiss the order or the case. Finally, in *Corbin* while the problem came to light prior to the issuance of the final order, the court noted that the defenses of laches would be applicable to circumstances involving greater delay. Thus, it is unlikely that even under Arizona law a rate order that had been final and operating for more than 2¾ years would have been reopened.

The MPUC's Docket 177 order then goes on to list five criteria it asserts should be utilized in exercising its alleged inherent authority for evaluating the need to reopen the 1984 Rate Order. In doing so, the Commission relies on *Northern States Power Co.*, Docket No. G-0002/GR-85-108, Order Vacating December 30, 1985 Order (February 19, 1986, Slip. Op.) (A-162)[8] and *Professional Air Traffic Controllers Organizations v. FLRA*, 685 F.2d 547 (D.C. Cir. 1982). Neither decision is applicable here.

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[8] This decision is currently on direct appeal to the Minnesota Supreme Court.

NSP involved a motion to reopen a prior order of the Commission brought within a few weeks of the issuance of the order reopened and within the time limits established by Commission rule for bringing motions for reconsideration. In the present case, that time limit expired several years ago. Also, in NSP the utility company itself was one of the parties who moved for and therefore consented to the reconsideration. In the present case, Northwestern Bell has never waived its right to be governed by the Minnesota Supreme Court approved 1984 Rate Order. Finally, in NSP the Commission was acting under different enabling legislation which specifically authorizes the reopening of rate orders in gas and electric cases at any time. Minn. Stat. § 216B.25. Rate case proceedings involving telephone companies are governed by Minn. Stat. Chapter 237 which, as was indicated earlier, has no similar provision authorizing the reopening of final orders.

In *PATCO, supra,* the court dealt with a violation of a federal statute which specifically prohibits ex parte contacts in federal administrative proceedings. In the present case, there was no statute, federal or state, which prohibited the contacts involving Northwestern Bell. Furthermore, in *PATCO* the court refused to set aside the agency decision involved despite the fact that the court found illegal ex parte contacts involving wining and dining had actually occurred in the case. The court did so because, despite the contacts, it found the final decision was not affected by the contacts. In the present case all the participants to the contacts have testified under oath that the Commission's decision was not affected by the contacts. Furthermore, the Commission made no finding that any specific issue or vote in Docket 600 was affected by any of the contacts.

Even if the five criteria the Commission derived from NSP/PATCO were applicable to the present case, however, they were not properly applied by the Commission. In addi-

tion the Commission, over Northwestern Bell's objection, ignored a sixth fundamental criterion.[9] The sixth fundamental criterion should have been formulated as follows:

> [6] What specific statute, rule or regulation, if any, was in effect during the relevant time period which prohibited each alleged conflict of interest or alleged ex parte communication?

As demonstrated earlier, there were no such applicable statutes, rules or regulations then in effect.

Furthermore, it is clear that the Commission did not even abide by the requirements of the five *NSP/PATCO* criteria it claimed to have set for itself. For example, the Commission listed as its second requirement, "Whether the contacts may have influenced the agency's ultimate decision." (April 2, 1987 Order, p. 6; A-114). This is an important criterion because in the *PATCO* case, which the Commission relied on in establishing its criteria, the court decided *not* to undo a prior decision despite the fact that it found illegal ex parte contacts had occurred during the case. The *PATCO* court also found, however, there was no proof that the final decision was improperly influenced by the statutorily prohibited contacts. If the Commission is going to rely on *PATCO* it should also follow it.

In the present case it is clear, however, the Commission did not apply the second criterion. On page 10 of its order, the Commission admits "it was difficult to accurately assess the effect NWB's actions had on particular votes on particular issues."[10]

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[9] NWB's Comments Regarding the MPUC's October 3, 1986 Order, dated October 22, 1986, pp. 15-16).

[10] Even this statement, which does not find there was an actual effect overstates the evidence. As indicated earlier there is no evidence on the record that any vote was affected and several Commissioners stated so during their November 7, 1986 deliberations.

Instead of applying the second criterion as stated, the Commission changed it and found not that any votes or issues had been affected but that an "impression" was created by Northwestern Bell's contacts of "an unduly receptive atmosphere." (April 2, 1987, Order, p. 10; A-118). The Commission cited no authority in support of this substituted criterion. Thus, the Commission failed to apply that criteria it said it was going to and the criteria it felt *PATCO* and *NSP* required.

Similarly, the Commission ignored its third *NSP/PATCO* criterion which it stated to be, "Whether the party making the improper contacts benefited from the agency's ultimate decision." This is a rather simple requirement to understand. Did Northwestern Bell, in fact, benefit in the final order from its alleged improper contacts.

Instead of applying this criterion, as stated, the Commission, ignored sworn testimony to the contrary, and found that the contacts in question were "intended" to benefit Northwestern Bell in Docket 600. (April 2, 1987 Order, p. 11). The Commission cited no authority for this substituted criterion. In addition, the Commission's finding under this criterion ignore contrary conclusions reported to it by its own staff.[11]

For the foregoing reasons it is clear that the Commission's order vacating the 1984 Rate Order was issued without statutory authority and the Commission's attempt to justify its actions based upon nonexistent inherent authority is meritless.

III. THE MINNESOTA SUPREME COURT'S DECISION IN *HENRY V. MPUC* THAT NORTHWESTERN BELL'S DOCKET 600 RATES ARE JUST AND REASONABLE BARS THE COMMISSION'S ACTION IN DOCKET 177 UNDER THE DOCTRINE OF RES JUDICATA.

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[11] See discussion of Joint Staff Report, *Supra*, 26-27.

The practical effect of the Commission's orders in Docket 177 vacating the 1984 Rate Order when combined with the Commission's action in Docket 600 is to illegally lower Northwestern Bell's rates which have been in effect for several years by $11.9 million a year. (See Commission order of April 3, 1987 in Docket 600).

As indicated earlier, Northwestern Bell's current rates were reviewed by the Minnesota Supreme Court in *Henry v. Minnesota Public Utilities Commission*, 392 N.W.2d 209 (Minn. 1986) and found to be just and reasonable and supported by substantial evidence in the record. (*Henry, supra*, pp. 215-216). Both the Commission and Northwestern Bell were parties of record to the *Henry* litigation. As such, both the Commission and Northwestern Bell are bound by the court's decision in *Henry* regarding the issue of whether or not the final order in Docket 600, the same order which is at issue in this proceeding, established rates that were just and reasonable.

Both the United States Supreme Court and Minnesota courts have held that the principles of res judicata apply to actions by administrative agencies. *U.S. v. Utah Construction & Mining Co.*, 384 U.S. 394, 422, 86 S.Ct. 1545, 1560, 16 L. Ed. 2d 642 (1966) and Hough Transit, Ltd. v. Harig, 373 N.W.2d 327, 332 (1985).

In *Henry* the court stated:

> "Based on our careful review of evidence in the record of this case and the 100-page order of the MPUC, we conclude that the decision of the MPUC was supported by evidence in the record and was not arbitrary and capricious. We therefore hold Northwestern Bell met its statutory burden of proof under Minn. Stat. § 237.075, Subd. 4 (1984) as to the rate increase order. (*Henry, id.*, p. 216).

Thus, in *Henry* the Minnesota Supreme Court has already ruled, as a matter of law, that the evidence in the record in Docket 600 establishes that the rates put into effect under the 1984 Rate Order were just and reasonable regardless of the procedures utilized in establishing those rates. The Commission, therefore, is bound by that decision and was not entitled to change it. If the Commission felt for whatever reason that Northwestern Bell's current rates which had previously been found to be just and reasonable were unjust and unreasonable, the Commission could have commenced a new rate proceeding to determine that issue and have afforded the company all its procedural rights under *Minn. Stat.* Chapter 237.

The Commission's deliberations in this matter totally ignored the applicability of the *Henry* decision until its order denying reconsideration of June 4, 1987 despite the fact that Northwestern Bell had repeatedly raised it throughout this proceeding. (NWB's Response to the AG-RUD's Reply Brief, September 15, 1986, p. 20; and NWB's Comments Regarding the MPUC's October 3, 1986 Order, October 22, 1986, pp. 43-44). The Commission's only response was to state that the issue of abuse of the Commission's process, which the Commission asserted as its legal basis for redeliberating Docket 600, was not before the court in *Henry*.

This response lacks merit for two reasons. First, it ignores the fact that in *Henry* the court held that *the evidence of record* supported the rates which were established as being just and reasonable. This would still be true even if NWB had attempted to bring additional evidence to the attention of the Commission regarding Docket 600 by ex parte means. (The latter circumstance, however, was denied under oath by all participants). The fact that the evidence of record support

the rate decision would also be true regardless of the motivation of the decision makers.

Second, the doctrine of res judicata not only bars issues which were raised and decided but also those which could have been raised. *In Re: McDonough*, 296 N.W.2d 648 (Minn. 1980); *Youngstown Mines Corp. v. Prout*, 266 Minn. 450, 124 N.W.2d 328 (1963); and *Nelson v. Dorr*, 239 Minn. 423, 58 N.W.2d 876 (1953). The Commission knew some of the facts involved in this matter as early as April 9, 1986 when it issued its order initiating the investigation. The Commission knew all of the facts upon which it based its decision as of July 8, 1986 when the Department of Public Services submitted its report. The Minnesota Supreme Court did not render its decision in *Henry* until a month later on August 8, 1986. Despite the fact that the Commission had this knowledge, it made no attempt to bring these issues to the attention of the Minnesota Supreme Court nor to request a stay of the appeal or remand of the case for the purpose of enabling the parties to deal with these issues and include them in the Docket 600 appeal.

Furthermore, the policy reasons underlying the doctrine of res judicata are applicable here. Parties need certainty and a reasonable end to litigation. Both the Commission and the Company need to be bound by prior Supreme Court decisions which declares particular orders of the Commission to be valid and final. Otherwise the conduct of any regulated business would be plagued with uncertainty and chaos.

Furthermore, any dissatisfaction the Commission had with the practices of parties in this case could have been and have been corrected by rulemaking. (A-137). Any concern regarding the present reasonableness or unreasonableness of the Company's rates can be resolved by the Commission's com-

mencing a new ratemaking proceeding rather than trashing one that has been in effect and final for several years.

IV. THE COMMISSION'S ORDER TO VACATE, REOPEN AND REDELIBERATE A 2¾ YEAR OLD FINAL RATE CASE ORDER VIOLATES THE 10 MONTH RULE OF *MINN. STAT.* § 237.075.

Even if the Commission had the authority and jurisdiction to vacate a 2¾ year old final order, and even if there were a proper factual basis for doing so based upon proceedings which did not violate the Company's due process rights, the Commission, nevertheless, should not have vacated the 1984 Rate Order and subsequently issued another rate order because the legal effect of said action is a violation of the 10 month rule of *Minn. Stat.* § 237.075, Subd. 2.

That statute requires the Commission to issue its final determination in a general rate case "within 10-months after the initial filing date." In the present case the initial filing date was September 29, 1983. The Commission's final determination of July 27, 1984 was within the 10 month period. The Commission's orders of April 2, 1987 and April 3, 1987 are well beyond it.

The Commission has stayed the ratemaking effects of its April 2, 1987 order in this matter and its new April 3, 1987 ratemaking order in Docket 600 pending judicial review of both orders. Once that stay is lifted, however, unless those orders have been overturned by this court the plain language of *Minn. Stat.* § 237.075, Subd. 2 would apply.

That statute specifically provides that in cases of a 10 month violation the schedule of rates initially filed by the Company (in this case calling for a $109 million annual increase) ". . . shall be deemed to have been approved by the Commission . . ." Thus, the legal effect of the Commission's

action of not issuing a "final determination" until after April 2, 1987 on a rate increase petition filed by the Company on September 23, 1983 would be to increase the Company's current rates by more than $50 million rather than decrease them by $11.9 million as the Commission intended to do in its April 3, 1987 order.

Furthermore, the Commission's own staff and the staff of the Department of Public Service advised the Commission in the Joint Staff Report[12] that the Commission's 1984 Rate Order established an authorized rate of return for the Company which was too low and established rates which did not produce sufficient revenue for the Company to earn either its authorized rate of return or required rate of return during 1985. Thus, while a rate increase resulting from the present docket would not be what the Commission intended, it would be no more inequitable than the Commission's decision to lower the Company's rates by $11.9 million annually in 1987 based on a 1983 test year without affording the Company due process of law.

V. THE PROCEDURES USED BY THE COMMISSION IN DOCKET 177 VIOLATED NORTHWESTERN BELL'S CONSTITUTIONAL AND STATUTORY RIGHTS.

Docket 177 was a summary investigation. (MPUC Order April 9, 1986 and MPUC Order, October 3, 1986). The DPS Report indicates that Northwestern Bell was officially designated a party to the investigation. (DPS Report, Ex. 55). Yet, the DPS Report also indicates Northwestern Bell was denied the rights of a party by the DPS during the investigation. For example, while the DPS required Northwestern Bell to

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[12] See discussion of Joint Staff Report, *Supra*, pp. 26-27.

have Northwestern Bell employees respond to interrogatories and requests for production of documents (DPS Report, Exhs. 49 and 53), the DPS refused to respond to interrogatories and requests for the production of documents propounded by Northwestern Bell. (DPS Report, Exh. 65). Northwestern Bell brought this to the Commission's attention but obtained no relief.

In addition, many of the exhibits to the DPS Report are documents which were not disclosed to Northwestern Bell during the investigation but only after the DPS Report was filed. [Exhs. 1-9, 11, 14-15, 30, 32, 37, 47, 51, 52, 55, 56 (Partial), 57-58, 59 (Partial), 63-64, 67, 71-72 and 91]. Since, many of the exhibits consist of affidavits or DPS memoranda to the file of interviews or telephone conversations regarding information provided to the DPS under circumstances which did not provide Northwestern Bell with notice or an opportunity to cross-examine or otherwise participate (Exhs. 32, 57-58, 67, 71 and 91) Northwestern Bell was denied fundamental due process rights in the manner in which these "exhibits" were compiled and unilaterally presented to the Commission.

The Commission, nevertheless, took administrative notice of the DPS Report, depositions and exhibits and considered them to be "evidence" of record. (MPUC Order, October 3, 1986, p. 3).

Northwestern Bell, therefore, gave written notice to the Commission and all parties to Docket 177 that, in addition to many other reasons, Northwestern Bell would object to any action taken by the Commission to reopen or reconsider the 1984 Rate Order based on the so called "evidence" created by the DPS under the "summary" investigative procedures involved in Docket 177. (NWB's comments, October 22, 1986, pp. 16-17).

The Commission did not order a contested case under *Minn. Stat.* § 237.075 and *Minn. Stat.* Chapter 14 as it had in producing the record which resulted in the 1984 Rate Order in Docket 600. Since this is a ratemaking proceeding which resulted in a lowering of the Company's rates based upon disputed issues and evidence, the Commission was required to do so. *State v. Tri-State Tel. & Tel. Co.*, 284 N.W. 294 (1939) ("Due process demands that rates be fixed only after a hearing attended by at least the rudiments of fairplay." *Id.*, at 300) and *Continental Tel. Co. of Minn., Inc.*, 389 N.W.2d 910 (Minn. 1986). Even under *Minn. Stat.* § 237.081, which was relied upon by the Commission in initiating Docket 177 (A-2) Northwestern Bell is entitled to a formal hearing prior to any order being issued which changes its rates. Northwestern Bell never received one.

It is Northwestern Bell's position that even assuming arguendo that the Commission has the authority to reopen a 2¾ year old final rate order, the Commission cannot and should not do so unless some party has produced evidence in a proceeding which affords Northwestern Bell its due process adversarial rights which meets a prima facie threshold enabling reopening. In its October 22, 1986 comments to the Commission, Northwestern Bell took the position that (1) since no party had come forward in Docket 177 with any evidence that Mr. Weir's contacts with Commissioners Adams and Hanson violated any statute, rule or regulation and (2) since there was no evidence that Docket 600 issues had ever been discussed in those meetings and (3) since all the sworn evidence of record established that no vote in Docket 600 had been affected by the contacts, the prima facie threshold had not been met and no further proceedings were appropriate or necessary.

If the Commission or any party disagreed with Northwestern Bell, the Commission should have submitted the matter to the Office of Administrative Law Judges for contested case pursuant to Chapter 14. The Commission's failure to do so resulted in the Commission issuing an order based on a record which denied Northwestern Bell statutory and constitutional rights.

Since the ultimate result of the proceedings in Docket 177 was to vacate an order which entitled Northwestern Bell to $56.5 million annually and later replaced with an order in Docket 600 which, if not reversed, would result in a $11.9 million reduction to Northwestern Bell, the Commission has confiscated Northwestern Bell's property in violation of its state and federal constitutional rights to due process and in violation of its statutory rights. *Bluefield Waterworks & Improvement Co. v. P.S.C. of W. Vir.*, 262 U.S. 679, 43 S. Ct. 675 (1923) and *State v. Tri-State Tel. & Tel. Co.*, 284 N.W. 294 (Minn. 1939).

CONCLUSION

For the foregoing reasons Northwestern Bell requests that this court reverse and vacate the Commission's orders in Docket 177 of April 2, 1987 and June 4, 1987 and reinstate the Commission's 1984 Rate Order.

Dated:

Respectfully submitted,
NORTHWESTERN BELL
TELEPHONE COMPANY

APPENDIX 2

C9-87-1297

STATE OF MINNESOTA
COURT OF APPEALS

NORTHWESTERN BELL TELEPHONE COMPANY,

Relator,

vs.

MINNESOTA PUBLIC UTILITIES COMMISSION,

Respondent.

BRIEF OF NORTHWESTERN BELL TELEPHONE COMPANY

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I. PROCEDURAL HISTORY

This case ("Docket 600") originated with a Petition for a general rate increase filed in September, 1983, by Northwestern Bell Telephone Company ("NWB"). After contested case proceedings, the Minnesota Public Utilities Commission ("MPUC") issued its initial decision on July 27, 1984 ("1984 Rate Order"). (A-6-106). The MPUC issued its Order After

Reconsideration and Rehearing on September 26, 1984. (A-107-119). On October 17, 1984 (A-120-127), the MPUC approved the implementation of new rates designed to increase NWB's authorized revenues by $57,511,000 annually. The new rates have been in effect since October 19, 1984.

A variety of appeals were taken from the MPUC's 1984 orders. This Court reversed two aspects of the MPUC's decisions (*see Application of Northwestern Bell Tel. Co.*, 367 N.W.2d 655 (Minn. App. 1985)), and the Minnesota Supreme Court affirmed these orders in all other respects in *Henry v. Minnesota Public Utilities Commission*, 392 N.W.2d 209 (Minn. 1986),[1] holding:

> "Based on our careful review of the evidence in the record of this case and the 100-page order of the MPUC we conclude the decision of the MPUC was supported by evidence in the record and was not arbitrary and capricious. We therefore hold Northwestern Bell met its statutory burden of proof under Minn. Stat. Section 237.075, subd. 4 (1984) as to the rate increase ordered." (392 N.W.2d at 216).

In April, 1986, the MPUC initiated a proceeding (Docket No. U-999/CI-86-177, ("Docket 177")) to investigate contacts between a Company representative and certain former Commissioners. The Department of Public Service ("DPS") conducted an investigation and submitted a Report to the MPUC on July 8, 1986. Thereafter, several parties to Docket 600

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[1] Additional appeals include *Application of Northwestern Bell Tel. Co.*, 371 N.W.2d 563 (Minn. App. 1985), *review denied*, Sept. 29, 1986 (relating to a January 10, 1985 order dealing with directory accounting matters), and *Application of Northwestern Bell Tel. Co.*, 374 N.W.2d 758 (Minn. App. 1985), *aff'd in part and reversed in part*, 386 N.W.2d 723 (1986) (relating to intervenor compensation in telephone rate proceedings).

moved the MPUC to reopen, reconsider or vacate the previous decisions in Docket 600. The Company opposed these requests.

The MPUC deliberated on these and other matters in November, 1986, and February, 1987. On April 2, 1987, it issued its order in Docket 177, vacating its 1984 Rate Order. The next day, the MPUC issued the Order After Redeliberation ("OAR") in Docket 600 based on the factual record, briefs and arguments presented in 1984. (A-130-269).

In the OAR, the MPUC reduced the previously authorized rate increase from $57,511,000 to $45,603,000 annually. (*See* A-267). The major revenue requirement changes made by the MPUC were: (1) to impute a hypothetical capital structure and hypothetical interest expense to NWB for purposes of calculating NWB's authorized rate of return and test year income tax expense (*Compare* A-78-79, *with* A-196-197, 226-231); (2) to impute $2.527 million of hypothetical directory revenues to NWB (A-71-74); and (3) to require NWB to continue to flow through in prospective rates a deferred income tax surplus that had already been flowed through in rates charged since 1982 (A-164-165).

The MPUC also altered the previously-approved metropolitan rate structure. (*Compare* A-103-104, para. b & c, *with* A-138, para. c) and, *sua sponte*, ordered NWB to provide certain services free to handicapped customers. (*Compare* A-104, para. m & n, *with* A-268, para. m & n).

NWB filed timely Petitions for Reconsideration of the OAR in Docket 600 and the April 2, 1987 order in Docket 177. By orders dated June 4, 1987, the MPUC denied both petitions. (*See* A-270-274 regarding Docket 600.)[2] The MPUC

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[2] NWB has separately appealed the MPUC's orders of April 2 and June 4, 1987, in Docket 177 to this Court in *Northwestern Bell Tel. Co. v. Minnesota Public Utilities Commission*, C9-87-1296.

denied reconsideration of the Docket 600 Petition without discussing any of NWB's substantive issues. However, it clarified and expanded its direction to NWB to provide free services to the handicapped. (Order Denying Reconsideration ("ODR") A-272-273).

NWB filed compliance tariffs as directed by the MPUC's orders, as well as tariffs and supporting documentation that more appropriately calculate the revenue impact, and the resulting rates for other services, of the MPUC's decision to require NWB to give away service. On July 21, 1987, the MPUC approved the compliance tariffs and rejected NWB's alternative tariffs and revenue calculations. (A-280-286).

On June 30, 1987, the MPUC stayed any requirements that NWB implement new rates pending the outcome of NWB's appeals. (A-275-279).[3]

II. ISSUES ON APPEAL

NWB separately appealed the MPUC's orders in Docket 177. Issues related to the propriety of the MPUC's decision to vacate the 1984 Rate Order will be addressed in that appeal and will not be addressed here.[4] If the Court determines that

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[3] The combined result of the Tier and handicapped services rate design decisions is that NWB's approximately 99,000 customers in Tiers 3 and 4 of the Metropolitan area will experience rate increases if the approved compliance tariffs are implemented, even though the MPUC reduced NWB's rate increase by approximately $12 million. By its ODR dated June 4, 1987, the MPUC specifically rejected a Suburban Rate Authority request that the MPUC reconsider the Tier decision. (A-274). However, a second petition for further reconsideration of the Tier issue was recently filed by the Suburban Rate Authority and that petition is presently pending before the Commission.

[4] Those issues include whether the MPUC had authority and jurisdiction to vacate the 1984 Rate Order in the manner in which it did, whether the procedures the MPUC followed were lawful, what is the appropriate legal impact of the MPUC's order vacating the 1984 Rate Order on NWB's current rates, and whether there was a factual record that supported the MPUC's vacation action.

the MPUC improperly vacated the 1984 Rate Order and reinstates the 1984 Rate Order, this appeal will be moot. However, if the Court affirms the vacation of the 1984 Rate Order, it will be necessary to consider the merits of the following issues raised in this appeal:

(1) Is the MPUC's decision to impute a hypothetical capital structure and cost of debt to NWB contrary to law, unsupported by substantial evidence and arbitrary and capricious?

(2) Is the MPUC's decision to impute hypothetical directory revenue to NWB contrary to law, unsupported by substantial evidence, and arbitrary and capricious?

(3) Is the MPUC's decision to require NWB to reduce rates prospectively due to a non-existent tax surplus contrary to law, unsupported by substantial evidence and arbitrary and capricious?

(4) Is the MPUC's decision to require NWB to provide services free of charge to certain customers contrary to constitutional principles and law, unsupported by evidence in the record and arbitrary and capricious?

(5) Were the procedures the MPUC utilized with regard to arriving at its decision contrary to NWB's constitutional right to due process of law, contrary to other legal standards and contrary to the provisions of Administrative Procedures Act?

III. STATEMENT OF FACTS

A. FACTS RELATED TO CAPITAL STRUCTURE.

In its OAR, the MPUC used a hypothetical capital structure to set NWB's rates, holding NWB had failed to establish the reasonableness of its actual capital structure. (A-227-230). Capital structure impacts the rate-setting process, because the cost of each type of capital (*i.e.*, debt and equity) is weighted

by its percentage of the total capital to determine NWB's overall rate of return.[5] (*See, Id.*, p. 103).

The record reflected the equity ratios of 17 telephone companies, including NWB:

Company	*Equity Ratio*
Cincinnati Bell	61.7%
Rochester Telephone	58.1%
AT&T	57.4%
Bell South	56.9%
Bell Atlantic	56.7%
Northwestern Bell actual	*56.4%*
Ameritech	56.2%
US West—used in 1984 Rate Order	*55.9%*
Southwestern Bell	55.4%
Southern New England Tel.	54.5%
NYNEX	54.9%
Pacific Telesis	53.5%
United Telephone	44.7%
Centel	43.5%
GTE	40.7%
Continental	38.8%
Mid-Continent	33.5%

[5] For example, if a company's capital structure were 60% common equity, at a cost of 15%, and 40% debt, at a cost of 10%, its overall cost of capital (its overall rate of return) would be 13% (60% x 15% + 40% x 10% = 13%). Capital structure also indirectly impacts allowable income tax expense, because interest paid on debt is a deductible expense for income tax purposes. Thus, hypothetically increasing the percentage of debt in a company's capital structure will not only reduce the overall rate of return (because debt is generally less expensive than common equity), it will also reduce allowed income tax expense by (hypothetically) increasing the interest deduction.

(Exh. 157, Sched. 2; Exh. 188, Sched. 11R, 13R; Exh. 150, Sched. 18.) The MPUC adopted a hypothetical equity ratio of 50.1%.

Four witnesses addressed the capital structure issue. William L. Bauhard, NWB's Assistant Treasurer, testified that NWB's service obligations require it to be able to raise large amounts of capital. That ability is enhanced by a AAA bond rating, which is affected by NWB's capital structure. (Exh. 15, pp. 5-6). Mr. Bauhard therefore recommended the MPUC use NWB's actual capital structure (56.4% equity, 43.6% debt) to set rates. (*Id.*, pp. 18-19). In rebuttal, Mr. Bauhard presented the capital structures of the seven regional Bell holding companies created at divestiture. Their equity ratios ranged from 53.5% to 56.9%, averaging 55.6%. (Exh. 188, pp. 26-27; Exh. 189, Scheds. 10R, 11R).[6]

Eugene W. Meyer, Vice President and Director of Kidder, Peabody & Co., explained that, to have ready access to the capital markets on reasonable terms, it would be essential for NWB to maintain a capital structure consistent with a AAA or AA bond rating. (Exh. 4, p. 11). Such a bond rating ensures access to a wider range of investors, thus enhancing NWB's ability to raise capital (*Id.*, p. 5). A lower bond rating would not produce a lower incremental cost of capital; however, if NWB's bond rating were lowered, raising it would be costly. (*Id.*, pp. 4-6; Exh. 5, App. C; Vol. 1, p. 146, lines 1-4).

Dr. Matityahu Marcus, testifying on behalf of the OAG, recommended the use of a capital structure consisting of 55% equity and 45% debt. (Exh. 149, p. 38). Later, the OAG

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[6] The testimony expressly states the *debt* ratios of these companies. Their equity ratios can be determined by subtracting the debt ratio from 100%.

urged the use of US WEST's actual capital structure containing 55.94% equity and 44.06% debt.[7] (Initial Brief of OAG, Vol. I, pp. 23-24).

Dr. Luther Thompson, on behalf of the DPS, recommended a structure of 50% equity, 43.6% debt and 6.4% imputed debt. (Exh. 196, p. 4). Asserting the MPUC must "balance" shareholders' needs against ratepayers' concerns, he argued the MPUC should not defer to NWB's actual capital structure "for regulatory purposes." (Exh. 156, pp. 4-5, 7).

Dr. Thompson based his recommendation on some—but not all—of the groups of companies analyzed by some of the rate of return witnesses. He calculated the average equity ratio of four telephone companies analyzed by Dr. Eilon Amit, the five telephone companies analyzed by Mr. Robert Morris,[8] the 25 electric companies analyzed by Mr. Bauhard, and four telephone companies and four electric companies analyzed by Dr. Litzenberger. Dr. Thompson selected these groups because their average bond ratings and average "betas" were similar to NWB's.[9] He also considered the capital structure used by the MPUC in NWB's 1982 rate case, containing 50.1% equity.

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[7] That, in fact, was the consolidated capital structure of US WEST's three operating telephone companies (Mountain Bell, Northwestern Bell and Pacific Northwest Bell). The structure thus did not reflect US WEST's other subsidiaries. (Exh. 189, Sched. 10).

[8] The Morris "group" contained the same four companies as the Amit group (Cincinnati Bell, Mid-Continent Telephone, Rochester Telephone and Southern New England Telephone) plus AT&T. (Exh. 157, Sched. 2, pp. 1-2). In fact, Mr. Morris analyzed the four "Amit" companies as a group, and AT&T separately. (Exh. 9, p. 7; Exh. 10, Sched. 2).

[9] "Beta" is a measure of the movement of the rate of return of a given stock, relative to the stock market as a whole. If that movement is relatively less than the market, the stock is perceived to be less risky than the market as a whole, and vice versa. (Exh. 7, p. 21).

(*Id.*, pp. 10-11).[10] He did not consider the Bell regional holding companies which were analyzed by Dr. Marcus (Exh. 149, p. 3), by Dr. Litzenberger in his supplemental testimony[11] (Exh. 217, p. 1), and by Dr. Amit in a secondary analysis. (Exh. 191, p. 36).

In its 1984 Rate Order, the MPUC rejected Dr. Thompson's recommendation:

> "The DPS analysis merely demonstrated that NWB's capital structure was not equal to the composite groups its witness, Dr. Thompson, had chosen for comparison purposes. Dr. Thompson never demonstrated that NWB's capital structure was imprudent or unreasonable. The Commission is not convinced by the DPS's argument and has rejected similar arguments in NWB, P-421/GR-82-203 at 32, and *NWB*, P-421/GR-80-911 at 45." (A-78).[12]

The MPUC, however, also rejected NWB's proposal to use its capital structure to set rates:

> "The Commission agrees that since divestiture, the same Bell System consolidated capital structure that the Company advocated using in its last rate case . . ., no longer exists and therefore it would be impossible to use that capital structure. However, although the actual entity has disappeared, the principle of using the parent company's consolidated capital structure, which has been the

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[10] In that case, decided before divestiture, the MPUC used the Bell System consolidated capital structure. (*Northwestern Bell Telephone Co.*, Docket No. P-421/GR-82-203, pp. 30-32 (April 20, 1983) ("203 Order")).

[11] Dr. Litzenberger withdrew his original analysis in favor of the analysis in his supplemental testimony. (Exh. 217, pp. 1, 16).

[12] In its 203 Order, the MPUC had stated:

> "The DPS analysis merely demonstrated that the Bell System equity ratio was not equal to the industry average, not that it was unreasonable or imprudent." (203 Order, p. 32).

> Commission's consistent practice in the last two NWB rate cases . . ., did not disappear with Bell System consolidated capital structure. The Commission finds it reasonable and appropriate, therefore, to use the consolidated capital structure of US WEST . . . to determine the overall rate of return in this proceeding." (*Id.*)

In the OAR the MPUC did an abrupt about-face. On the basis of two precedents—its own Central Telephone rate order (which had been *reversed* by this Court)[13] and a Louisiana Supreme Court decision[14]—the MPUC rejected the principle that it could impose a hypothetical capital structure only on a showing that NWB's actual structure was unreasonable. (A-227-229). Rather, NWB had the burden of proving the reasonableness of its actual capital structure, which, the MPUC held, it failed to do. (A-229-230). Relying on Dr. Thompson, the MPUC adopted a hypothetical capital structure containing 50.1% equity to set NWB's rates. (*Id.*, p. 101).

B. FACTS RELATED TO DIRECTORY ADJUSTMENT.

In 1983, NWB decided to have its directories published by US West Direct, an affiliate. To facilitate this transition, NWB transferred certain assets (charged against retained earnings of the shareholders) to Landmark Publishing (Direct's parent company) and entered into a series of contracts with Direct. (A-54, 197). The MPUC was notified of the transfer in December, 1983, and it directed that the issues related to the transfer be considered in Docket 600.

In its initial presentation NWB did not adjust its test year financials to reflect the change in operations; from the

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[13] *Central Telephone Company*, Docket No. P-405/GR-83-300 (March 30, 1984), *reversed, Central Telephone Co. v. Minnesota PUC*, 356 N.W.2d 696 (Minn. App. 1984).

[14] *South Central Bell v. Louisiana P.S.C.*, 373 So.2d 478 (La. 1979).

ratepayers' perspective, rates would be set as though NWB had remained in the publishing business. (A-54, 198). This approach insulated ratepayers from any claimed detrimental effects of the transfer.[15]

Based on incomplete data available in February of 1984, NWB's financial expert testified that the change in operations, if considered by the MPUC, would likely be beneficial to the ratepayers. The best information, then available to NWB (based on FCC/MPUC prescribed accounting procedures), indicated that the change in operations could reduce revenue requirements by about $827,000 annually. He also testified that this estimate—largely because of inadequacies in accounting data—was not sufficiently reliable for use in a rate analysis. (NWB Exh. 270, p. 26, lines 3-18).

Other parties objected to the transfer, urging the MPUC to set it aside and order NWB to resume directory publication. They also attempted to show that the ratepayers would be worse off after the transfer. For example, the OAG estimated NWB would lose about $9.6 million in 1985 revenue, while the DPS estimated the revenue loss in that year (if the transfer were recognized) would be $3,183,000.[16] But, as long as NWB's financial presentation was on a business-as-usual basis, *none* of these alleged losses would be reflected in

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[15] The only change reflected in the financial data was a change in capital structure that had the impact of *reducing* NWB's recommended rate of return by 4 basis points. Thus, the reflection of this effect was beneficial, not detrimental to the ratepayers.

[16] These estimates were succinctly critiqued in NWB's Reply Brief to the Hearing Examiner, dated May 4, 1984, at pages 172-178, copies of which are included in the Appendix at pages A-304-311, and in NWB's Supplemental Statement of Facts in its Reply Brief, at pages 2-7, in *Application of Northwestern Bell Tel. Co.*, 367 N.W.2d 655 (Minn. App. 1985), copies of which are included in the Appendix at pages A-312-318.

rates *until after the next general rate proceeding,* and then *only* if the MPUC found it appropriate to do so.

In its 1984 Rate Order, the MPUC ordered NWB to resume publishing directories. NWB appealed and this Court reversed; it held prior MPUC approval of the transfer was not required, but noted:

> "The Commission's hands aren't completely tied. If it decides the contract was not in the best interests of the ratepayer *and that the fees paid by West Direct to Northwestern were unreasonable,* it can make an adjustment to Northwestern's rate request." (367 N.W.2d at 661, emphasis added).

The Court of Appeals also held:

> "The Commission's order voiding the agreement transferring Northwestern's directory operations is reversed. Accordingly, this case is remanded to the Commission to enter findings consistent with this opinion and the Commission is ordered to reinstate the contract between Northwestern and West Direct. *The Commission can make a review of the transfer and its future impact on Northwestern's rates on a more complete record in the next rate case. If appropriate, an adjustment can be made at that time.*" (367 N.W.2d at 663, emphasis added).

On redeliberation in 1987, the MPUC accepted the 1984 Hearing Examiner's recommendation that pre-tax income be increased by $2,526,666 "to allow for the impact of the removal of directory operations during the time the rates would be in effect." The MPUC's stated rationale was that the "benefits [of the transfer] appear to lay heavily on the side of US West's shareholders without a corresponding benefit falling to Minnesota ratepayers." (A-203).

C. FACTS RELATED TO TAX FLOW THROUGH.

In the 1983 203 Order, the MPUC adjusted test year financials to amortize, over a three year period, an identified deferred tax reserve surplus resulting from a reduction in the federal tax rate from 48% to 46%. (A-29). Thus, commencing in July, 1982, NWB's rates were reduced to flow the alleged excess reserve back to the ratepayers. (A-30).

As part of the 1984 Rate Order, the MPUC decided to continue to flow the remaining excess deferred taxes through to ratepayers via reduced rates over the three year period:

> "The Commission finds that the reduction in the federal income tax rate from 48% to 46% was an extraordinary event that effectively created a surplus in the Company's accumulated deferred federal income tax account. *The Commission concludes that the surplus tax reserve should continue to be amortized over a three year period as ordered in NWB, P-421/GR-82-203* to insure that a greater proportion of the amortization will be received by ratepayers who actually paid income taxes at the prior 48% tax rates." (A-30, emphasis added).

The new October 1984 rates continued to reflect the flow through.[17]

Thus, since July, 1982, NWB's rates have been reduced for the express purpose of returning a specific tax surplus to the ratepayers. The MPUC's scheme was predicated upon specific adjustments to revenue requirements designed and intended to eliminate the surplus over three years. By late 1985 the entire surplus had been returned to ratepayers in the form of reduced rates.

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[17] The flow through had also been reflected in the interim rates established by the MPUC in November of 1983 in this proceeding because, pursuant to Minn. Stat. § 237.075, subd. 3, interim rates had to be based on the substantive decisions made by the MPUC in the 203 Order.

Nonetheless, in the OAR the MPUC ordered NWB to implement new rates (effective May 14, 1987), reflecting the continued flow through of the surplus that had been fully amortized nearly two years earlier. (*See* A-164-165). The MPUC also denied reconsideration without discussion of this issue.[18] (A-271).

D. FACTS RELATED TO FREE SERVICE.

NWB provides a variety of central office based optional services that simplify, expedite and enhance customers' ability to use the telephone. Two such services are Touch Tone and Speed Call 8.[19]

In the 1984 Rate Order, the MPUC concluded that Touch Tone is an adjunct to local service and increased the rates for that service in relationship to the local rate increase. (A-99). With regard to Speed Call 8, the MPUC generally agreed to the price increase proposed by NWB, but added:

> "The Commission is aware that the speed-calling feature may facilitate use of the telephone system by persons with certain physical or mental impairments. In order to facilitate the use of the telephone system by these persons, the Commission will set the rate for the speed-calling 8 feature at $1 for customers who indicate to the Company that the service is used by a physically or mentally impaired person." (A-100).

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[18] NWB argued this issue *for the first time* in its Petition for Reconsideration because the surplus *had not* been fully extinguished at the time of the 1984 Rate Order and because the MPUC did not allow the filing of new briefs or arguments prior to the issuance of the OAR.

[19] Touch Tone enables a customer to dial a number by pushing number buttons on the telephone, rather than using a rotary dial. Speed Call 8 service enables a customer to dial up to eight numbers by dialing preprogrammed two-digit codes, rather than the complete telephone number, for each of the eight preprogrammed numbers.

In the OAR the MPUC expanded the 1984 Rate Order as it affected these services. The MPUC determined that Touch Tone "may facilitate the use of the telephone system by persons with certain physical or mental impairments" (A-258) and ordered NWB to provide the service "to qualified physically or mentally impaired persons without charge." (*Id.*) The MPUC determined that Speed Call 8 service should also be provided free to those persons, instead of at the $1 rate established in the 1984 Rate Order. (A-259).

NWB requested reconsideration of both decisions, noting: (1) the scope of the order was unclear (*i.e.*, whether "without charge" applied to both recurring and non-recurring charges and to residential and business services); (2) the revenue effect of these decisions (based on company estimates) could be millions of dollars; (3) the lost revenues would have to be recovered from other customers; and (4) there was no evidence at all to support the MPUC's actions. The MPUC denied reconsideration, but clarified the OAR. First, the MPUC decided that *both* recurring and nonrecurring charges are to be foregone, but that the decision applies only to residential services. Eligible customers were defined as those having a household member certified by a qualified authority[20] to have a disability requiring the use of Speed Call 8 or Touch-Tone service. (A-272). Finally, the MPUC directed NWB to determine the amount of recurring and nonrecurring revenue obtained from the provision of these services to eligible customers during 1983. That amount was to be recovered in other rates. (A-273-274). In other words,

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[20] A "qualified authority" includes doctors, nurses, ophthalmologists, optometrists, therapists, professional staff of hospitals, institutions and public welfare agencies, and professional librarians or any person whose competence is acceptable to the Librarian of Congress. (A-272).

NWB was required to assume that providing services free would not increase the number of eligible customers who would subscribe.

NWB is aware of no evidence to support the MPUC's decision to require NWB to provide these services free, or the MPUC's method of calculating the revenue NWB will lose or the increased costs that NWB will incur as a result of providing these services free.

NWB's compliance filing included two sets of customer estimates and revenue calculations and rates: one based on the MPUC-ordered methodology, and the other on a methodology NWB believed would more closely track reality if NWB provides free service to substantial numbers of customers. The MPUC's order of July 21, 1987 (A-281-282), shows the following comparisons:

	MPUC Method	*Company Method*[21]
Touch Tone customers that will subscribe	38,489	232,889
Touch Tone recurring revenues foregone	$531,148	$3,353,748
Speed Call 8 customers that will subscribe	330	123,889
Speed Call 8 recurring revenues foregone	11,880	$4,429,080
Total non-recurring revenue foregone for both services	37,326	$1,429,080

[21] These numbers are apparently derived from NWB's filing that the MPUC refused to consider. However, the total number of Speed Call 8 customers and total non-recurring revenues as set forth in the MPUC's order (and thus in this chart) differ somewhat from the data filed by NWB.

The MPUC refused to consider NWB's estimates of lost revenue. It approved the compliance rates NWB filed based on the MPUC's method for estimating lost revenue. (A-283-284). Thus, if more current customers demand free services, NWB will lose the current revenues from those customers. If additional customers demand free services, NWB will not recover any of the non-recurring or recurring costs it will thereby incur.

Dozens of vendors (including Target, Sears, Wards, K-Mart, Radio Shack, Best-Buy, Penney's, Spiegel and AT&T and many others) sell or lease telephone equipment providing both touch tone and speed calling features in direct competition with the services NWB has been ordered to give away.

E. FACTS RELATED TO OTHER ERRORS.

1. Denial of Oral Argument.

When the MPUC issued the 1984 Rate Order the Commissioners were Leo G. Adams, Harry Seymour Crump, Roger L. Hanson, Terry Hoffman, and Cynthia A. Kitlinski. (*See* A-6, 107, 120). By the time the MPUC redeliberated and issued the OAR and ODR, Commissioners Adams, Hanson and Hoffman had been replaced by new Commissioners, Barbara Beerhalter, Robert J. O'Keefe and Darrel L. Peterson. (*See* A-130, 270.) Despite its requests, NWB was afforded no opportunity to present oral argument on the merits of its 1983 Petition to the majority of the Commissioners who issued the OAR (*See* A-284-285), or to present oral argument to any of the Commissioners on its Petition for Reconsideration of the OAR. (*See* A-286-288.)

2. Failure to Deal With Issues Raised In the Petition for Reconsideration.

After the issuance of the OAR, NWB filed an extensive Petition for Reconsideration pointing out many of the errors the MPUC made in the OAR, including: (1) the Supreme Court's decision in the *Henry* case, *supra*, barred the MPUC's action (*See* NWB's Petition, pp. 2-3, 26-27, 39-41); (2) this Court had reversed the *Central* decision, which the MPUC had relied upon as authority to adopt a hypothetical capital structure, and that this Court had reaffirmed the validity of *Northwestern Bell v. State*, 216 N.W.2d 841 (Minn. 1974), in *Petition of Northern States Power Co.*, 402 N.W.2d 135 (Minn. App. 1987) (*See* NWB's Petition, pp. 5-7); (3) the entire tax surplus had already been flowed back to ratepayers and the OAR subjected NWB to grave tax risks (*See* NWB's Petition, pp. 27-31); (4) the imputation of directory revenues is contrary to a prior Minnesota Supreme Court decision and this Court's decision in *Application of Northwestern Bell Tel. Co.*, 367 N.W.2d 655 (Minn. App. 1985) (*See* NWB's Petition, pp. 31-34); and (5) no evidence supported the MPUC's actions with regard to Touch Tone and Speed Call 8 services and those actions were arbitrary and capricious. (*See* NWB's Petition, pp. 37-39).

The MPUC's OAR did not discuss any of these matters. Neither did the ODR; rather, the ODR simply states:

> "The Commission finds that the parties have raised no new arguments or evidence in Petitions for Reconsideration that have not already been thoroughly considered by the Commission." (A-271).

3. Failure to Make Requisite Findings and Basing Prospective Rates on Out-of-Date Financial Data.

As noted earlier, the MPUC issued its OAR and the ODR based on a record created in 1984. One of the express purposes of those orders was to reduce NWB's rates commencing May 14, 1987. (A-266). When the MPUC issued those orders, it had no evidence before it to establish that the record compiled in 1984 was adequate to set prospective rates.

In fact, prior MPUC decision established the contrary. In June, 1986, the Federal Executive Agencies (based on matters unrelated to the MPUC's decision to redeliberate this case) asked the MPUC to investigate the reasonableness of NWB's current rates. (A-287). In that proceeding, Docket P-421/CI-86-354, the MPUC ordered the DPS and the MPUC staff to investigate the reasonableness of NWB's rates. (A-288-289). In mid-1986 the MPUC received a Joint Report showing that in 1985 NWB (based on the rates set by the MPUC in the 1984 Rate Order) had been unable to earn *either* its authorized return or the substantially higher market-required return. (A-292). Therefore, in an order dated October 24, 1986, the MPUC determined:

> "It is in the public interest to determine reasonable rates based upon a full, fair record. To make this determination, the Commission will need to know NWB's 1986 costs and revenues, and these are not yet known. *The Commission concludes that it must base its decision on complete 1986 data.*" (A-294, emphasis added).

The MPUC also observed that a variety of substantial pending matters would have a "significant financial impact on NWB's earnings after 1986. (A-294). Accordingly, the MPUC ordered NWB to submit a detailed financial filing on April 1, 1987. (A-295-297). NWB submitted that filing, and a

scant two days later, on April 3, 1987, the MPUC issued its OAR—based on 1983 data—cutting "current rates" by more than $12 million annually. Thereafter, on May 27, 1987, the MPUC further decided that it:

> "[C]annot resolve all questions regarding the reasonableness of NWB's current rates to its satisfaction and that sufficient grounds exist to warrant a contested case hearing to determine whether NWB's current rates are just and reasonable or would result in excessive and unreasonable earnings for the Company." (A-299).

Thus, in October, 1986, the MPUC squarely recognized that NWB's rates set in 1984 had been inadequate in 1985 and that careful examination of 1986 data was necessary in order to set prospective rates. Yet, in the OAR issued six months later, the MPUC used 1983 data to set prospective rates without affording NWB the benefit of any hearing at all. Two months after that, it decided it could not determine the reasonableness of the rates set by the OAR without contested hearings.

IV. ARGUMENT

A. THE MPUC ERRED IN USING A HYPOTHETICAL CAPITAL STRUCTURE TO SET NORTHWESTERN BELL'S RATES IN THE OAR.

In the OAR, the MPUC used a hypothetical capital structure, consisting of 50.1% equity, 43.6% debt and 6.3% imputed debt, to redetermine NWB's revenue requirement. That is contrary to the Supreme Court's decision in *Henry, supra,* contrary to law, arbitrary and capricious, and not supported by substantial evidence, considering the record as a whole. The MPUC should have used US WEST's actual capital structure (55.9% equity, 44.1% debt), as it did in its 1984 Rate

Order[22] or NWB's capital structure (56.4% equity, 43.6% debt), as NWB recommended.[23]

1. The MPUC's Capital Structure Determination is Barred by the Supreme Court's Decision in the *Henry* case.

In the OAR, the MPUC stated:

> "[T]he Commission concludes that NWB has presented no convincing evidence as to the reasonableness of its capital structure for ratemaking purposes and has thus failed to sustain its burden of proof . . . ." (A-230).

The MPUC is wrong as a matter of law.

In the 1984 Rate Order, the MPUC considered the capital structure issue and determined to use US WEST's capital structure, based on its application of "the unreasonable or imprudent" standard and its view that the evidence presented by the DPS was insufficient to establish unreasonableness. (A-78). That Order was appealed ultimately to the Supreme Court, which disposed of a challenge to the sufficiency of the evidence as follows:

> "We will review the MPUC's determination of a just and reasonable rate in this case *according to the substantial evidence standard for rate of return determinations* and the arbitrary and capricious standard for rate design determinations. (citation omitted) Based on our careful review of the evidence in the record of this case and the

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[22] The MPUC adjusted US WEST's capital structure to remove the effects of NWB's transfer of directory operations to US WEST Direct, which it had attempted to void. (1984 Rate Order, p. 75). This Court later overturned that attempt. (*Re Northwestern Bell Telephone Company*, 371 N.W.2d 563 (Minn. App. 1985)). Thus that adjustment is no longer appropriate.

[23] This error affected not only the calculation of the overall rate of return, but also the calculation of interest for purposes of ascertaining test-year tax expense and the calculation of cash working capital. These aspects of the OAR must also be corrected.

> 100-page order of the MPUC, we conclude the decision of the MPUC was supported by evidence in the record and was not arbitrary and capricious. *We therefore hold Northwestern Bell met its statutory burden of proof* under Minn. Stat. Sec. 237.075, subd. 4 (1984) as to the rate increase ordered." (*Henry v. Public Utilities Commission*, 392 N.W.2d 209, 216 (1986), emphasis supplied).

In assessing the rate of return evidence, the Supreme Court had to consider capital structure. As this Court has stated:

> "Capital structure is one component used in determining overall rate of return by weighing the cost of capital by its percentage in the company's capital structure— . . . . " (*Petition of Northern States Power Co.*, 402 N.W.2d 135, 140 (Minn App. 1987)).

The issue of capital structure was fully litigated before the MPUC in 1984 and reviewed by the Supreme Court, which held, as a matter of law, that NWB met its burden of proof. That determination became the law of the case, and the MPUC cannot now reverse it. *Janssen v. Neal*, 256 N.W.2d 292 (Minn. 1977); *State by Johnson v. Sports & Health Club*, 392 N.W.2d 329 (Minn. App. 1986). Nor can this Court change the result on this appeal:

> "There exists a well-established rule that issues considered and adjudicated on a first appeal become the law of the case and will not be reexamined or readjudicated on a second appeal of the same case." *Lange v. Nelson-Ryan Flight Service, Inc.*, 263 Minn. 152, 155, 116 N.W.2d 266, 269 (1962).

This rule applies to matters adjudicated before the MPUC and reviewed by the appellate courts. *See Minnesota Power & Light Co. v. Minn. P.U.C.*, 342 N.W.2d 324 (Minn. 1983).

Moreover, once the MPUC's 1984 Rate Order, which utilized the "arbitrary or imprudent" standard, was affirmed by the

Supreme Court on this issue, the MPUC was powerless to use a different standard in its redeliberation:

> "Since our prior decision the membership of the court has changed. If we were to assume that the arguments of the defendant presently advanced on the issues previously determined might now be persuasive to a majority of the court, we nevertheless are not at liberty under this rule to engage in a reexamination, much less to so declare. This attitude is consistent with the rule of the law of the case and is founded upon a policy which requires that issues once fully litigated be set at rest." *Lange v. Nelson-Ryan Flight Service, Inc., supra,* 263 Minn. at 155, 116 N.W.2d at 269.

Regardless of the merits of the standard used in the OAR, the MPUC erred by using it in the face of a contrary Supreme Court decision on the prior appeal.

2. The MPUC's Capital Structure Decision is Contrary to Established Law.

The seminal case concerning the regulatory treatment of capital structure issues in Minnesota is *Northwestern Bell v. State,* 299 Minn. 1, 216 N.W.2d 841 (1974). There the Supreme Court stated:

> "We have difficulty accepting the concept that *in a rate case of this kind* the state may collaterally attack the judgment of the company in maintaining its embedded debt at a low figure. We agree with the position of the company that *this is a discretionary matter of management . . .*" (*Id.* at 14-15, 216 N.W.2d at 850; emphasis supplied).

Though this passage plainly states a general rule, the MPUC dismissed it as merely reflecting the state of the record, which did not contain "competing capital structure proposals." (A-228-229).

This Court has considered—and reaffirmed—the application of *Northwestern Bell* to capital structure issues three times.[24] *Peoples Natural Gas Co. v. Minnesota P.U.C.*, 342 N.W.2d 348 (Minn. App. 1983), involved an unincorporated division of InterNorth. Since it had no capital structure of its own, Peoples proposed the use of InterNorth's capital structure; the MPUC used a hypothetical structure containing less equity. This Court held the MPUC did not have to find Peoples' structure unreasonable before it could use a hypothetical capital structure because:

> "*Northwestern Bell* applies to utilities that have an objective capital structure of their own." (*Id.* at 352).

With no objective capital structure, Peoples' proposal was hypothetical and thus entitled to no deference.

In *Central Telephone Co. v. Minnesota P.U.C.*, 356 N.W.2d 696 (Minn. App. 1984), the MPUC used the capital structure of Centel, Central's parent, rather than Central's own structure. (*Id.* at 698). The MPUC held *Northwestern Bell* no longer applied because of the intervening passage of Minn. Stat. § 237.075, subd. 4, and that Central had to prove the reasonableness of its capital structure. (*Id.* at 702). This Court rejected the notion that this statute had implicitly overruled *Northwestern Bell*, noting that its *Peoples Natural Gas* opinion had expressly stated the continued vitality of that decision. Thus, the MPUC's decision was based on an error of law. (*Id.*)[25]

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[24] The most telling fact about the OAR is its disregard of these three decisions, which received *no* mention.

[25] Here, the MPUC made essentially the same argument, stating:

> "a substantive or legal presumption in favor of a company-proposed capital structure . . . would be inconsistent with . . . Sec. 237.075, subd. 4 . . ." (A-228).

Finally, in *Petition of Northern States Power Co.*, 402 N.W.2d 135 (Minn. App. 1987), the MPUC imposed a hypothetical capital structure, stating:

> " 'NSP has not come forward with sufficient evidence to justify the reasonableness of its capital structure for ratemaking purposes.' " (*Id.* at 140).

With a citation to Northwestern Bell, this Court reversed the MPUC, holding it should have utilized NSP's actual structure, "especially since the record shows it to be within the normal range for comparable utilities." (*Id.*)

There can be no question of the continued vitality of *Northwestern Bell,* or of its applicability to NWB, which has its own capital structure. Nor can there be a serious question as to the meaning of the case, though the MPUC asserts otherwise:

> "The Commission does not believe that the Supreme Court in [*Northwestern Bell*] *v. State* established as a matter of law that the Commission must first determine that the company-proposed capital structure is unreasonable before it evaluates or selects an alternative proposal. In that decision the Court conducted its review on the basis of the record before it. That record did not contain competing capital structure proposals." (A-228).

The short answer is that both *Central Telephone, supra,* and *Northern States Power, supra,* contained "competing capital structure proposals," yet, in each case, this Court reversed the MPUC's attempt to require the utility to prove the reasonableness of its actual capital structure. Indeed, *Central Telephone* is virtually indistinguishable from this case—except that the "hypothetical" capital structure there was the parent's actual structure; here, the MPUC used a wholly fictitious structure.

In *Central Telephone*, this Court noted the MPUC's "strict adherence to *Northwestern Bell* in recent cases," in which the MPUC had used the unreasonable or imprudent standard. (356 N.W.2d at 702). In other words, that standard is the standard of *Northwestern Bell*, just as the Company has claimed all along.

3. The MPUC's Capital Structure Determination Is Arbitrary and Capricious.

The MPUC's capital structure determination is also contrary to its own precedents. In NWB's 1982 general rate proceeding, the MPUC stated:

> "In *Northwestern Bell Telephone Co. v. State* . . . the Minnesota Supreme Court indicated that the Commission may not readily substitute its judgment for that of company management on the issue of appropriate capital structure. While this decision does not give utility management absolute discretion, the Commission believes that the capital structure must be found unreasonable or imprudent before the Commission chooses a different structure." (203 Order, at 32; *See also, United Telephone Co.*, Docket No. P-430/GR-82-200 (April 27, 1983)).[26]

While the MPUC can overrule its own precedents, it must provide sufficient reasons for doing so. (*Central Telephone Co. v. Minnesota P.U.C., supra,* 356 N.W.2d at 702; *Peoples Natural Gas Co. v. Minnesota P.U.C., supra,* 342 N.W.2d at 352-53).

Here, the MPUC made no effort to justify its departure from its own precedents. Instead, it simply denied the conflict, stating that:

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[26] In the 1984 Rate Order in this proceeding, the MPUC dismissed the DPS's recommendation, stating: "Dr. Thompson never demonstrated that NWB's capital structure was imprudent or unreasonable." (A-27).

> "in so far [sic] as they may be interpreted to suggest that there must be a finding of unreasonableness of a company's proposed structure before an alternative is entertained, [these decisions] are clarified by this Order." (A-229).

But the 203 Order flatly stated:

> "the Commission believes that the capital structure must be found unreasonable or imprudent before the Commission chooses a different structure." (203 Order, p. 32).

That these words require "clarification" is dubious, at best; that they can be interpreted as the MPUC now suggests—the opposite of their plain meaning—is nonsense. The words simply will not bear the meaning the MPUC now wishes them to carry, and no reasonable person could so find.

To support its conclusion in the OAR that NWB had the burden of proving the reasonableness of its capital structure, the MPUC cites and relies on Minn. Stat. § 237.075, subd. 4. (A-227). But this Court has expressly rejected the notion that this statute overruled Northwestern Bell and requires the utility to prove the reasonableness of its capital structure. (*Central Telephone Co. v. Minnesota P.U.C., supra,* 356 N.W. 2d at 702).[27]

The MPUC must "give reasons for departing from its prior norms and decisions." (*Id.*) Implicit in that is the requirement that the reasons form a legitimate basis for the decision, which plainly is not the case here. The MPUC's decision is arbitrary and capricious and must be reversed. (*Id.*)

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[27] The OAR also cites Rule 301 of the Minnesota Rules of Evidence as support for the four-step procedure the MPUC purported to follow here. (A-228). However, the MPUC denied any intent to effect substantive changes by means of this procedure (*Id.*), and Rule 301 has nothing to say about who has the burden of proof on a given issue in a rate case.

4. The MPUC's Capital Structure Determination Is Not Supported By Substantial Evidence Viewing the Record Whole.

No matter who had the burden to prove what, the record establishes the reasonableness of NWB's actual capital structure. The seven regional Bell holding companies created at divestiture provide the vast bulk of exchange telephone service in this country, serving some 80% of all telephone subscribers. (*See United States v. Western Elec. Co., Inc.*, 569 F. Supp. 990, 993 n. 8 (D.D.C. 1982)). The record indicates that these companies' equity ratios range from 53.5% to 56.9%, averaging about 55.6%. (Exh. 189, Scheds. 10R, 11R; Ex. 188, pp. 26-27). NWB's equity ratio of 56.4% and US WEST's equity ratio of 55.9% are thus "within the normal range for comparable utilities" and should not have been rejected by the MPUC. *Petition of Northern States Power Co., supra,* 402 N.W.2d at 140.

Unwilling or unable to contradict or explain away this evidence, the MPUC just ignored it. The OAR makes no mention of the equity ratios of the regional Bell holding companies, even though they were put into the record expressly for the purpose of demonstrating the reasonableness of NWB's actual capital structure. (Ex. 188, pp. 26-27).

This is particularly outrageous, in that the MPUC, citing Dr. Thompson's testimony, surveyed *some* of the comparable groups used by *some* of the rate of return witnesses in their cost of equity analysis, to determine its hypothetical capital structure. (A-230-231). These groups did not include the regional Bell companies, even though they were the subject of Dr. Marcus's and Dr. Litzenberger's rate of return analyses (Ex. 149, p. 3; Ex. 217, p. 1) and of Dr. Amit's secondary analysis. (Ex. 191, p. 36). Instead, the MPUC looked at the capital structures of the four telephone companies ana-

lyzed by Dr. Amit, the same four companies, plus AT&T, analyzed by Mr. Morris, four telephone companies and four electric companies initially analyzed by Dr. Litzenberger (who later discarded that analysis in favor of a subsequent analysis of the regional companies), and 25 electric companies analyzed by Mr. Bauhard. The MPUC's "analysis" of these groups consisted of calculating their mean (average) equity ratios and averaging the averages. (Ex. 157, Sched. 2).

Two of the five groups were from another industry: forty percent of the analysis did not even involve telephone companies. One of the three groups of telephone companies (Centel, Continental Telephone, Mid-Continent Telephone, and United Telephone) came from a rate of return study withdrawn by its sponsor. The other two groups each consisted of four companies (Cincinnati Bell, Mid-Continent Telephone, Rochester Telephone, and Southern New England Telephone) plus, in one case, AT&T. Thus, Mid-Continent Telephone—a tiny fraction the size of NWB—was counted three times, while the regional Bell companies—80% of the industry—were ignored. Rational decisions are not made this way.

The three telephone-company groups relied on by the MPUC have a total of eight companies, with equity ratios ranging from 33.54% to 61.69%. (Exh. 158). One can conclude from these data only that telephone companies have vastly different capital structures, which is essentially what the MPUC concluded in the 1984 Rate Order and in the 203 Order, when presented with similar data (A-78; 203 Order, pp. 31-32).[28]

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[28] Assuming electric companies have any relevance to the capital structure determination (as opposed to return on equity), they show similar disparities. The 29 electric utilities in the Bauhard and Litzenberger groups have equity ratios ranging from 36.34% to 51.45%. (Ex. 157, Sched. 2, pp. 3-4).

For all these reasons, the MPUC erred in using a hypothetical capital structure in this proceeding. Its OAR should, therefore, be reversed with a mandate to reinstate its original determination utilizing the capital structure of US WEST or to utilize NWB's capital structure.[29]

B. THE MPUC'S DECISION TO IMPUTE HYPOTHETICAL DIRECTORY REVENUES IS CONTRARY TO LAW, UNSUPPORTED BY SUBSTANTIAL EVIDENCE AND ARBITRARY AND CAPRICIOUS.

1. The MPUC's Decision to Impute Revenues Is Barred By This Court's Decision in the Prior Appeal.

Issues related to the directory transfer and the appropriate regulatory response were before this Court in *Application of Northwestern Bell Tel. Co.*, 367 N.W.2d 655 (Minn. App. 1985). This Court was there informed that NWB's financial data had been so presented as to insulate ratepayers from any adverse impact of the directory decision and that, because of deficiencies in the available accounting data, there were differences of opinion regarding the ultimate impact on ratepayers. (*See* A-313-318). In light of this controversy, this Court reversed the MPUC's decision to order NWB to resume publishing directories. In light of the fact that ratepayers had been protected, and the existing controversy about the ultimate effect of the transfer, this Court held:

> "Accordingly, this case is remanded to the Commission to enter findings consistent with this opinion and the

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[29] If the Court agrees that the *Henry* decision established the law of the case on this issue, the MPUC should be directed to use US WEST's capital structure, as it did in the 1984 Rate Order. If, however, the MPUC was free to reconsider this issue in the OAR, it should have used NWB's capital structure, and the Court's mandate should so direct it now. As noted earlier, these structures closely approximate each other.

> Commission is ordered to reinstate the contract between Northwestern and West Direct. The Commission can make a review of the transfer and its future impact on Northwestern's rates *on a more complete record in the next rate case.* If appropriate, an adjustment can be made *at that time.*" (367 N.W.2d at 663, emphasis added).

In a subsequent, related decision, this Court upheld an MPUC order imposing substantial new, detailed accounting requirements on the Company with regard to directory matters so that more reliable and complete information would be available in the next case. (*See Application of Northwestern Bell Telephone,* 371 N.W.2d 563 (Minn. App. 1985)).

The MPUC ignored this Court's direction. It did not enter findings consistent with the Court's opinion. Nor has it abided by the Court's admonition that adjustments, if appropriate, should be made after an evaluation, based on a more complete record, in the next rate proceeding. Instead, based on the same record—with no new evidence—the MPUC made rate adjustments. The law is clear that the MPUC cannot act contrary to the reviewing Court's mandate. In *Holden v. Farwell, Ozmun, Kirk & Co.,* 34 N.W.2d 920 (1948), the Supreme Court held, that on remand, not only the express findings and conclusions in the Supreme Court's decision had to be followed, but also any findings inherent and implicit in that decision. *See, also, In Re Estate of Boysen,* 351 N.W.2d at 398, 400-401 (Minn. App. 1984); *Tankar Gas, Inc. v. Lumbermen's Mut. Casualty Co.,* 9 N.W.2d 754, 758 (1943). Here the MPUC acted flatly contrary to this Court's mandate.

The MPUC's action is also contrary to the law of the case as established by this Court. *See Lange v. Nelson-Ryan Flight Service, Inc., supra*; *see also, Minnesota Power & Light Co. v. Minn. P.U.C.,* 342 N.W.2d 324 (Minn. 1983). It is also barred

by the doctrine of *res judicata*. *Roseberg v. Steen*, 363 N.W.2d 102, 105 (Minn. App. 1985); *Hauser v. Mealey*, 263 N.W.2d 803, 806 (Minn. 1978); *Shimp v. Sederstrom*, 233 N.W.2d 292, 294 (Minn. 1975).

The MPUC could not, consistent with the Court's prior decisions, make major adjustments to NWB's revenue requirements.

2. The MPUC's Decision To Impute Directory Revenues Is Contrary To Other Applicable Principles of Substantive Law.

Under Minnesota law, the MPUC can make affiliated interest adjustments only in limited circumstances. In *Northwestern Bell Telephone Company v. State*, 216 N.W. 841, 854 (Minn. 1974), the Supreme Court held:

> "[I]t seems to us unreasonable to arbitrarily penalize the company for doing business with an affiliate where there is no evidence that subscribers would benefit by the company's securing supplies elsewhere. That is not to say that if prices charged both by the affiliate and by its competitors are exorbitant and improperly reflect leverage obtained by monopolistic practices, the commission would not be warranted in disallowing what is excessive."

As noted by this Court in *Application of Northwestern Bell Tel. Co.*, 367 N.W.2d at 661, the MPUC's authority is limited to "disregard[ing] *unwarranted* payments to affiliates when calculating the 'just and reasonable' rates." 367 N.W.2d at 661, emphasis added.

The MPUC ignored these standards. It did not analyze the directory contracts or find them to be substantively inappropriate in the fashion required by the Supreme Court. It made no meaningful attempt to adjust the Company's rate

case financials to reflect the impact of the contracts. All the MPUC has done is express a vague concern about the relative benefits of the contracts and impose a heavy penalty upon the Company because the MPUC dislikes the transfer.

This is obvious because NWB's rate case financials were presented on a business-as-usual basis—*i.e.*, as though the transfer had never taken place—and the ratepayers were fully insulated from any alleged detrimental financial effects of the transfer. The MPUC's OAR captures *all* of the benefits of the business-as-usual approach and, by imputing additional hypothetical revenues to NWB—"to allow for the impact of the removal of directory operations"—, the MPUC has placed the ratepayers in a better position than they would have been if the transfer had never taken place. Thus, under the OAR, NWB is placed in the anomalous position of suffering a $2.5 million penalty[30]—and the ratepayers get a $2.5 million windfall—merely because NWB made a lawful business decision with which the MPUC disagrees.

3. The MPUC's Decision To Impute Hypothetical Directory Revenues to the Company is Not Supported By Substantial Evidence and is Arbitrary and Capricious.

Major adjustments to NWB's test year financials must be supported by substantial evidence. *See, e.g., Henry v. Minnesota Public Utilities Commission*, 392 N.W.2d 209, 216 (Minn. 1986); *Hibbing Taconite Co. v. Public Service Commission*, 302 N.W.2d 5, 9 (Minn. 1980). The major adjustment to directory revenues adopted by the MPUC is without such support.

As discussed earlier, NWB's business-as-usual approach fully protected ratepayers. Beyond that, however, the adjust-

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[30] The MPUC has no jurisdiction to impose penalties. *See Coastal Oil & Gas Corp. v. FERC*, 782 F.2d 1249 (5th Cir. 1986); *Southern Union Gas Co. v. FERC*, 725 F.2d 99 (10th Cir. 1984).

ment adopted by the MPUC was faulty in several major respects. The adjustment was not sponsored by any witness to the proceeding; it was merely a refinement of a calculation constructed by the DPS for the first time in its Brief to the ALJ.

Moreover, the adjustment completely ignored the fact that —pursuant to FCC and MPUC prescribed accounting systems —many directly related expenses (*i.e.*, expenses associated with pensions, profit sharing, payroll taxes and general overhead) are not separately identifiable and were not taken into account in the adjustment. (*See* Exh. 359). Thus, the expenses considered in constructing the adjustment are hopelessly erroneous.

Similarly, the adjustment is predicated upon continuation of historical growth in directory revenues. The evidence was to the contrary, demonstrating that past revenue growth was attributable almost entirely to price increases, not volume growth. (Tr. Vol. 45, p. 71). At the end of 1983, directory advertising prices in Minnesota were among the highest in the nation and widespread price cutting and increased competition in the industry was anticipated. (Exh. 317, p. 4; Tr. Vol. 45, p. 71, p. 92). In short, there was no basis to assume that growth in directory revenue was sufficiently certain to form the basis for a major adjustment. *See Northwestern Bell Tel. Co. v. State*, 253 N.W.2d 815, 822 (Minn. 1977).

C. THE MPUC'S DECISION TO REQUIRE THE COMPANY TO REDUCE RATES PROSPECTIVELY DUE TO A NON-EXISTENT TAX SURPLUS IS CONTRARY TO LAW, UNSUPPORTED BY SUBSTANTIAL EVIDENCE AND IS ARBITRARY AND CAPRICIOUS.

The OAR requires NWB to reduce rates to reflect a specific deferred tax surplus *that no longer exists.* Pursuant to

prior MPUC's orders, rates have been reduced on a continuous basis since 1982, so that the entire surplus has been extinguished. Yet the OAR and the MPUC's subsequent orders require NWB to reduce rates prospectively, as though ratepayers are entitled to future rate discounts based on the nonexistent surplus.

This MPUC's decision is contrary to law and confiscatory because it results in an arbitrary reduction in NWB's cost of service and the establishment of rates insufficient to earn the MPUC authorized rate of return. This is contrary to Minn. Stat. § 237.075, subdivisions 5 and 6 and NWB's constitutional right to avoid confiscation of its property.

The decision is also contrary to the decision of this Court in *Application of Northwestern Bell Tel. Co.*, 367 N.W.2d 655 (Minn. App. 1985). One of the issues there was whether the MPUC could require NWB to amortize and return to ratepayers unamortized investment tax credits that NWB no longer owned. This Court held the MPUC erred by reducing NWB's cost of service to reflect non-existent credits. (367 N.W.2d at 661-663). The MPUC attempted essentially the same thing here. It wants to give the ratepayers continuing credit—on a prospective basis—for a surplus that no longer exists.

The situation here is analogous to the investment tax credit issue in the Court's prior decision in another respect. There, this Court determined that the MPUC's decision to reflect non-existent tax credits in the Company's cost of service would violate the Internal Revenue Code. Precisely the same situation exists here.

The Internal Revenue Code requires the "normalization method of accounting" be followed in order to qualify for accelerated depreciation for tax purposes. (Section 167(1)

(3)(G)). Corresponding IRS regulations provide that the taxpayer loses its tax deferral if it fails to normalize. (Treasury Regulation 1.167(a)-11(b)6.) In addition, Treasury Regulation § 1.167(1)-1(h)(2) states:

> "The taxpayer must credit the amount of deferred Federal income tax determined under subparagraph (1)(i) of this paragraph for any taxable year to a reserve for deferred taxes, a depreciation reserve, or other reserve account. The taxpayer need not establish a separate reserve account for such amount but the amount of deferred tax determined under subparagraph (1)(i) of this paragraph and must be accounted for in such a manner so as to be readily identifiable. *With respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal incomes taxes are greater by reason of the prior use of different methods of depreciation* under subparagraph (1)(i) of this paragraph. An additional exception is that the aggregate amount allocable to deferred tax under section 167(1) may be properly adjusted to reflect asset retirements or the expiration of the period for depreciation used in determining the allowance for depreciation under section 167(a)." (Emphasis added).

The Code and Treasury Regulations could not be more explicit. The adjustment adopted by the MPUC violates the normalization standards contained in the Code and regulations and the IRS could easily take the position that, because of this adjustment, the availability of significant accelerated depreciation deductions are lost, to the serious detriment of NWB's Minnesota customers. As an independent tax accountant, Mr. Jeter, testified:

"The impact would be to increase the cost of service. The Company and the Minnesota ratepayers would lose an important source of cost-free capital." (Exh. 39, pp. 21-22).

In this case, the MPUC has failed to consider that its decision violates the Internal Revenue Code and regulations and, as a result of the decision, NWB may lose its right to utilize accelerated depreciation for tax purposes and lose an important source of cost free capital. Failure to consider this likely adverse consequence of its decision renders the MPUC's action arbitrary and capricious.

Finally, there simply is no evidence—the MPUC cites none in either of its orders—to justify the MPUC's decision that ratepayers must continue to receive a windfall, in the form of reduced prospective rates, due a surplus already fully returned to them.

D. THE MPUC'S DECISION TO REQUIRE THE COMPANY TO GIVE SERVICES AWAY FREE OF CHARGE IS CONTRARY TO LAW, UNSUPPORTED BY SUBSTANTIAL EVIDENCE AND IS ARBITRARY AND CAPRICIOUS.

The MPUC's orders requiring NWB to give away services and dictating the method of calculating the resulting loss are affected by major errors and must be reversed.

1. The Requirement That the Company's Must Give Away Services Violates Minn. Stat. § 237.21.

Minn. Stat. § 237.21 prohibits the MPUC from approving any rate that tends to destroy competition or to create a monopoly. This statute obviously exists to protect competition and insure its benefits to ratepayers. The MPUC's decision to require NWB to give Touch Tone and Speed Call 8 services free to eligible customers is contrary to this statute. Other

vendors marketing equipment that provide competitive services obviously cannot compete with NWB's "free services." Thus, other vendors are being foreclosed—by virtue of the MPUC's decision—from major segments of the market for their equipment.[31] The destruction of competition in this manner was precisely what Minn. Stat. § 237.21 was intended to prevent.

2. The MPUC's Decision Is Not Supported By Adequate Findings.

The MPUC's decision to require NWB to give away services is not supported by adequate findings. First, the ability to demand free services is not related to an eligible customer's ability to pay for the service. Under the MPUC's decision, a wealthy eligible customer is entitled to free service. Thus, the MPUC's plan is not reasonably related to the objective the MPUC seeks to achieve—or at least the MPUC has not made findings to demonstrate that fact.

Second, this decision is not supported by reasonably detailed findings necessary to demonstrate that the MPUC has engaged in reasoned decision making. *Yellowbird, Inc. v. MSP Express, Inc.*, 377 N.W.2d 490, 494 (Minn. App. 1985). For example, the OAR and the ODR contain no findings at all on a variety of critical matters—including how many customers are eligible, how many currently subscribe to the services; how many will subscribe if the services are free; the financial impact of the decision on NWB; and the impact on its competitors. Absent such findings, this Court cannot conclude the MPUC engaged in reasoned decision making.[32]

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[31] NWB estimated, for example, that 232,889 customers would be eligible for free Touch Tone service and 123,889 customers would be eligible for Speed Call 8 services. (A-281-282).

[32] Of course, the MPUC could not make findings on these critical issues because no one was aware that the MPUC was even contemplating requiring NWB to give away services and *no* evidence was introduced on these issues.

3. The MPUC's Decision Is Not Supported By Any Evidence and Is Arbitrary and Capricious.

NWB is not aware of any evidence, or any proposal made by any party, suggesting NWB should give away Touch Tone or Speed Call 8 services to the class of customers the MPUC has defined. Nor is NWB aware of any evidence supporting the MPUC's method of determining the revenue NWB will lose, or additional costs NWB will incur, as a result of the MPUC's decision.

The MPUC simply decided—as a matter of the exercise of its will, rather than the exercise of reasoned judgment—that NWB could afford to give away services to handicapped customers. When the MPUC made its decision, it had no evidence of the number of customers eligible for free services, or how many of them actually subscribe to these services, or how much revenue NWB would lose, or what additional costs NWB would incur. Simply stated, there was no basis upon which the MPUC could make an informed judgment on these matters.

The MPUC cannot justify its actions on the grounds that it involves rate design. Even there, the MPUC cannot act in an arbitrary fashion and must engage in reasoned decision making. Its action does not meet even these minimal standards and must be reversed. Moreover, the method of computation dictated by the MPUC is not merely a matter of rate design; it directly affects NWB's ability to earn its authorized rate of return. The MPUC is not free to manufacture a revenue calculation out of whole cloth, thereby negating major portions of the approved rate increase and undermining NWB's ability to earn the authorized return. Yet, that is precisely what it did here; it required NWB to assume, without any basis in fact, that it has the same number of eligible customers

today that it had in 1983; it required NWB to assume, without any basis in fact, that only those customers eligible for service in 1983 will subscribe to these services today, when they are free. Of course, both assumptions are nonsense and serve only to confiscate NWB's property.[33]

4. The MPUC's Decision Confiscates the Company's Property.

The MPUC's decision confiscates NWB's property in several respects. It prohibits NWB from charging a reasonable rate for its services in violation of Minn. Stat. § 237.06. It also disables NWB from developing the market for these services at reasonable rates. NWB estimates the size of the market—in terms of annual revenue from eligible customers—being foreclosed to it is more than $9 million. (App-287). Finally, the MPUC has precluded NWB from recovering costs it will undoubtedly incur in providing free services to new, eligible customers that subscribe to these free services.[34] Confiscation of this sort is constitutionally prohibited and must be condemned by this Court.

5. The MPUC Lacks Jurisdiction to Require the Company to Give Away Service.

Pursuant to Minn. Stat. § 237.06, NWB is obligated to charge reasonable rates. Under § 237.075, subds. 5 and 6 and

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[33] The proof of this is obvious. If the MPUC believed that its assumptions were sound, there would have been no reason to require NWB to forego non-recurring charge because under the MPUC's assumptions, no additional customers would subscribe to the services and incur the non-recurring charges.

[34] The MPUC's attempt in its July 21, 1987 Order, to avoid this problem by requiring NWB to report actual results at the end of six months' experience of providing free services, is of no avail. All that Order offers is six months of confiscation with an undefined suggestion that something might be done about the matter at a later date. (A-284).

§ 237.081, the MPUC is obligated to set just and reasonable rates. Nothing in these statutes suggests that "without charge" for a valuable service might constitute a "just and reasonable rate." In fact, Minn. Stat. § 237.21 suggests the contrary, particularly when there are competitors in the market. The MPUC has exceeded its authority and jurisdiction.

The MPUC cannot justify its decision on the ground that it is free to provide subsidies to needy subscribers in order to promote universal services or to "facilitate the use of the telephone system" by handicapped persons. The MPUC's decision is not based upon inability to pay for services. Under the MPUC's orders a wealthy subscriber with a handicapped child is eligible for free services.

Moreover, the legislature recently demonstrated it has retained, and is willing to exercise, authority to determine what subsidies are appropriate for particular classes of customers. During the past session, and only after extensive debate, the legislature adopted a Telephone Assistance Plan for the elderly (Minn. Laws, Chapter 340, §§ 13-17, Minn. Stat. §§ 237.69-237.72 (1987)) and a plan to assist the handicapped to procure equipment to enable them to improve their access to the telephone network. (Minn. Laws, Chapter 308, Minn. Stat. §§ 237.50-237.56 (1987)). Had the legislature believed that further subsidies—in the form of free services—were necessary to "facilitate" the use of the network, the legislature certainly would have adopted such a program. It did not; and the MPUC cannot.

E. THE ORDER AFTER REDELIBERATION AND THE ORDER DENYING RECONSIDERATION ARE AFFECTED BY SUBSTANTIAL LEGAL AND PROCEDURAL ERRORS.

1. Denial of the Company of the Opportunity to Present Oral Argument to a Majority of the Commissioners Who Rendered These Decisions Violates Due Process and the Administrative Procedures Act.

The MPUC issued the OAR in April, 1987, based on the prior record, without affording NWB an opportunity to present oral argument on the merits, even though NWB's Exceptions to the Hearing Examiner's Report requested the opportunity to do so. (A-310). Similarly, the MPUC issued the ODR without allowing NWB to present oral argument. In both instances, the MPUC either overlooked or ignored NWB's specific requests to present argument. (*See* A-312-313).

Because three of the current Commissioners are new since the 1984 Rate Order, NWB has been given no opportunity to argue the merits to a majority of the MPUC that issued the OAR and ODR. NWB has thus been deprived of its constitutional and its statutory rights.

Minn. Stat. § 14.57 requires agencies to decide contested matters in the manner specified in the Administrative Procedures Act. Minn. Stat. § 14.61 requires that decisions in contested cases shall not be made unless each party adversely affected has been afforded an opportunity to "*present argument to a majority of the officials who are to render the decision.*" "Argument" means "oral argument" and a request to present argument *cannot* be overlooked or denied. (*See Matter of Haugen*, 278 N.W.2d 75 (Minn. 1979); *Yellowbird, supra*; *In the Matter of Determining the Natural Ordinary High Water Level of Lake Pulaski*, 384 N.W.2d 510, 515 (Minn. App. 1986)).

Moreover, as pointed out by the Minnesota Supreme Court in *Haugen, supra*, ". . . . even apart from the statute, basic concepts of fair play . . . require" that a party be given a

meaningful opportunity to present argument before the officials who will be deciding the merits of a contested case. If that opportunity is not granted, there is a "lack of basic fairness in the decision making process." *Yellowbird, supra.* Such basic fairness is guaranteed by both the state and federal constitutional.

Here, the right to present oral argument was particularly crucial: the MPUC—with three relatively inexperienced new members who had little personal knowledge of the case—undertook to redecide dozens of complex issues on the basis of the prior record, filings and staff briefings. Even though millions of dollars were at stake,[35] and despite specific requests for the opportunity to do so, NWB was given no opportunity to argue the merits of its position to the new majority of Commissioners. The MPUC's actions violated the literal terms of Minn. Stat. § 14.61 and NWB's fundamental right to basic fairness as part of the decision making process.

2. The MPUC's Failure to Deal With Substantive Issues Raised on Reconsideration is Error.

The MPUC is required to deal fairly and impartially with all material issues raised by the parties (Minn. Stat. § 14.62, subd. 1) and make findings sufficient to allow meaningful appellate review of its action. As the Supreme Court held in

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[35] As previously noted, the MPUC reduced the rate increase from $57.5 to $45.8 million, has ordered NWB to reduce rates prospectively by that amount, has conditioned the stay it issued pending appeal upon a requirement that NWB make refunds retroactive to May 14, 1987, in the event the MPUC's new decisions are affirmed, and has instructed the OAG to sue NWB to recover the difference between the previously authorized rate increase and the newly authorized increase for the period from November, 1983, through May 14, 1987. The OAG recently initiated that litigation, based on the MPUC's OAR, in Hennepin County District Court.

Hibbing Taconite Co. v. Minn. P.S.C., 302 N.W.2d 5, 12 (Minn. 1980):

> "Henceforth, we deem it necessary that the PSC set forth factual support for its conclusion. The PSC must state the facts it relies on with a reasonable degree of specificity to provide an adequate basis for judicial review. We do not require great detail but too little will not suffice."

The failure to do so is not only reversible error as to specific matters or issues, but also indicates the MPUC has not engaged in reasoned decision making, but has exercised its will rather than its judgment. *Yellowbird, supra.*

In this case, the MPUC has failed to fulfill its responsibilities. It made no findings on the substantive issues raised by NWB in its Petition for Reconsideration. The ODR belies any suggestion that NWB's Petition was given meaningful consideration by the MPUC. For example, NWB's Petition specifically raised the following new matters for the first time:

—the Supreme Court's decision in 1986 in the *Henry* case foreclosed action taken by the MPUC in the OAR—both as a general matter and with regard to the use of a hypothetical capital structure.

—the MPUC's *Central* decision (cited and relied heavily upon by the MPUC in the OAR (*See* A-227-228, 230)) had been *reversed* by this Court in *Central, supra,* 356 N.W.2d 696 (Minn. App. 1984).

—this Court's capital structure determination in *NSP, supra,* 402 N.W.2d 135 (Minn. App. 1987), was contrary to the OAR.

—the imputation of directory revenues was contrary to Minnesota Supreme Court decisions and the prior directory decision of this Court.

—the entire surplus associated with the 48%/46% tax rate change had already been returned to ratepayers and that any continuation of the flow through, as required by the OAR was contrary to law, was not supported by the record and subjected NWB to serious tax risks.

—the MPUC's new decision to require NWB to give services away was unlawful and could cost NWB millions of dollars on an annual basis.

Remarkably, in the ODR the MPUC claimed that nothing new had been raised that had not been already thoroughly considered—even though these matters had not been considered at all.[36] In addition to ignoring these serious matters in the ODR, the MPUC undertook—without any legal or factual basis—to expand dramatically the burdens imposed on NWB by increasing the level of services it must give away.

The MPUC has failed to deal fairly with the issues, has failed to make findings to support its actions and has failed to engage in reasoned decision making:

> "[W]here there is a combination of danger signals which suggest the agency has not taken a 'hard look' at the salient problems and 'has not genuinely engaged in reasoned decisionmaking' it is the duty of the court to intervene." (*Yellowbird, supra,* 377 N.W.2d at 493; *Reserve Mining Co. v. Herbst,* 256 N.W.2d 808, 824-25 Minn. 1977)).

Here, the MPUC took no look—let alone a "hard-look"—at salient issues raised by NWB.

3. The MPUC Erred In Attempting to Set Prospective Rates Based on Out-of-Date Financial Data.

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[36] Indeed, the Court will search in vain for any mention of these matters in the OAR *or* the ODR.

Here the MPUC has attempted to use a 1983 test year, adjusted for divestiture, to set prospective rates. Yet, the MPUC made no findings to support the use of the 1983 test year for that purpose. In *Northwestern Bell Telephone Co. v. State*, 253 N.W.2d 815, 822 (Minn. 1977), the Court defined the appropriate use of a test year concept in rate-making proceedings as follows:

> "[T]he test-year concept is designed to produce a measure of a regulated utility's earnings for a known period of time, to enable the regulatory body to make an accurate prediction of revenues and expenses in the reasonably near future. Based upon the evidence presented, the regulatory body undertakes a reasoned exercise of its discretion in altering test-year data to reflect changes of known magnitude occurring subsequent to the test year." (Citations omitted).

Test year 1983 is not reasonably representative of current conditions. There was no rational basis for the MPUC's use of the 1983 data to set 1987 rates and the MPUC has acted in an arbitrary and capricious fashion. Indeed, the MPUC has acknowledged in Docket 354 that more current information is necessary: in its order dated October 24, 1986, the MPUC expressly recognized that not even 1985 data could be used to set prospective rates[37] and that fair and reasonable rates could be set only after a careful examination of complete 1986 financial data, and the resolution of a variety of other substantial matters that would significantly affect NWB's post

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[37] The MPUC and DPS Joint Staff Report showed that, based on 1985 data, NWB's required rate of return was substantially higher than authorized in the 1984 Rate Order and that in 1985 NWB did not even earn the lower authorized return. (A-292). Of course, this is directly contrary to the suggestion in the OAR that rates during this period were excessive. (A-266).

1986 earnings. (A-284). Yet, five months after making these determinations, and without giving any consideration to current conditions, the MPUC issued the OAR slashing current rates by more than $12 million annually. Its action was obviously contrary to law, unsupported by substantial evidence and arbitrary and capricious.

V. CONCLUSION

For the reasons set forth above, NWB respectfully requests this Court to reverse and vacate the MPUC's OAR and ODR in this matter and to remand this matter to the MPUC with instructions to reinstate the 1984 Rate Order in all respects.

APPENDIX 3

C7-87-1296
C9-87-1297

STATE OF MINNESOTA
IN SUPREME COURT

NORTHWESTERN BELL TELEPHONE COMPANY,
Petitioner,

v.

MINNESOTA PUBLIC UTILITIES COMMISSION,
Respondent.

PETITION FOR SUPREME COURT REVIEW

Northwestern Bell Telephone Company ("NWB") seeks review of the Court of Appeals' decision of December 28, 1987, which affirmed two Minnesota Public Utilities Commission ("MPUC") orders. These orders re-opened a three-year-old

final telephone rate case order and prospectively lowered NWB's annual revenue by twelve million dollars. In addition, the Minnesota Attorney General has sued NWB for a three-year refund of revenue already collected under the 1984 final Order. Therefore, the decision of the Court of Appeals jeopardizes approximately sixty million dollars of NWB's shareholders' property.

Supreme Court review is necessary because:

1. In violation of statute and of principles articulated by the Supreme Court, the Court of Appeals has taken the unprecedented step of endowing the Commission with unlimited "inherent" authority to re-open and re-decide a prior contested rate proceeding, previously affirmed on appeal to the Supreme Court, without requiring the MPUC to follow any of the statutorily required procedures in contested rate cases.

2. The Commission deprived NWB of its right to be heard in the reconsideration of the rate case, in violation of this Court's October 1987 opinion in *In re the Petition of Northern States Power Company*, 414 N.W.2d 383, 388 (Minn. 1987) ("NSP").

3. Even though the Commission stated it was unable to determine that the 1984 rate decision was specifically affected by NWB's challenged contacts with the Commission, which were not proscribed by statute or rule, it removed millions of dollars of previously approved rate relief necessary for a fair return on NWB's shareholders' investment as an extreme and unauthorized penalty. Additionally, rate reductions for NWB necessarily affect the compensation NWB pays to over 90 independent telephone companies.

4. The Court of Appeals and the Commission have ignored statutory limitations on the Commission's authority in a novel but misguided effort to protect public confidence in the rate

making process. The Supreme Court's intervention is required to harmonize the cases and the statutory limitations on the Commission's authority.

5. The hypothetical capital structure imposed by the Commission is unsupported by substantial evidence, is drastically different from that unanimously approved in 1984, and constitutes an improper penalty.

STATEMENT OF THE CASE

NWB's 1983 petition to the MPUC (the "Docket 600" petition) sought approval of a $109 million annual rate increase. After nine months of contested proceedings, the MPUC in 1984 granted NWB approximately $57 million in rate relief. In doing so, the MPUC voted 5-0 to impose the capital structure sought by the Attorney General and used by NWB's parent U.S. West, which was based on a ratio of 56.4 percent equity. On appeal, the Supreme Court, after a "careful review" of the evidence and the Commission's 100-page order, held that NWB had met its statutory burden of proof. *Henry v. Minnesota Public Utils. Comm'n,* 392 N.W.2d 209, 216 (Minn. 1986).

In April 1986, while Henry was on appeal, the Minnesota Department of Public Service (the "DPS") began an independent investigation of contacts between utilities and certain former Commissioners. After the submission of the DPS report to the MPUC on July 8, 1986, which criticized certain contacts between NWB and Commissioners Adams and Hanson, several parties moved to re-open the Docket 600 rate case. On April 2, 1987, the MPUC concluded that it was unable to determine that any of the rate decisions were specifically affected by these contacts. It nevertheless granted the motions to reconsider. On April 3, the Commission reduced NWB's 1984 rate increase from $57,511,000 annually to $45,603,000.

By a 5-0 vote, the MPUC imputed to NWB a hypothetical capital structure that included an equity ratio of 50.1 percent. The drastic change of this one issue, which was not found to be tainted by the contacts, reduced NWB's revenue by over ten million dollars annually.

NWB unsuccessfully moved for reconsideration and appealed. The Court of Appeals affirmed, holding that the Commission has "inherent authority," analogous to the district court's power granted by Rule 60 of the Minnesota Rules of Civil Procedure, to re-open and re-decide rate case orders regardless of how long they have been final.

LEGAL ISSUES

1. Does the MPUC have "inherent" authority to re-open a three-year-old final order, previously affirmed by the Supreme Court, in a contested telephone rate proceeding?

2. If the MPUC has such authority, was it properly exercised by a reversal of decisions unaffected by the challenged actions and the imposition of a penalty of millions of dollars?

The Court of Appeals answered both questions in the affirmative.

ARGUMENT

The re-opening and redeliberation of the 1984 rate case exceeded the Commission's statutory authority, deprived NWB of its procedural rights and denies its shareholders the opportunity to earn a reasonable return on their investment.

The telephone rate-making statute, Minnesota Statutes Section 237.075, carefully delineates the MPUC's authority and jurisdiction in rate cases. It does not give the MPUC any authority to re-open a rate case. The powers of the MPUC, a creation of the Legislature, are limited to those granted by, or logically necessary to the exercise of those granted by, the legislature. *Peoples Natural Gas Co. v. Minnesota Public*

Utilities Comm'n, N.W.2d 530, 534 (Minn. 1985); NSP, supra at 387-388. Jurisdiction lies more properly in the district court, a court of general jurisdiction statutorily authorized by the Administrative Procedure Act to hear and decide issues of procedural irregularities outside the record that arise during an appeal. See, e.g., *Minn. Stat.* § 14.68. In permitting the Commission to exercise an unlimited, undefined and unprecedented "inherent authority," the Court of Appeals has totally disregarded the limits on authority granted by the Legislature and has permitted the Commission unfettered discretion to suspend the statutes and rules. This Court must not likewise suspend its authority to supervise the compliance of a governmental agency with its statutory directives.

It is important to recognize that the contacts challenged here are different in kind and degree from those in *NSP*, supra. NWB's contacts consisted of conversations over meals paid for by NWB, on matters other than the rate case, and did not involve any employment negotiations. In *NSP*, on the other hand, the MPUC investigated an offer of employment, later accepted, by NSP to a sitting Commissioner during a contested rate case. Furthermore, unlike the telephone rate statute, the electric and gas statute explicitly authorized the reopening of rate cases, and NSP timely requested reconsideration of that case. *NSP, supra*, at 387.

By contrast, the MPUC's action toward NWB:

1. Occurred many years after the rate case was decided and affirmed on appeal by the Supreme Court.

2. Lacked any statutory authority.

3. Was based on conduct not prohibited by a then existing statute or rule.

4. Was not limited to reconsideration of issues affected by the contacts.

5. Was not invited by NWB.

The Commission's unanimous reversal of its 1984 vote on capital structure, and its imposition of a hypothetical structure in the face of overwhelming evidence to the contrary can only be explained as punitive. In effect, the MPUC imposed sanctions of twelve million dollars annually without authority and without a hearing.

For the foregoing reasons, NWB requests Supreme Court review of the unprecedented decisions of the Court of Appeals and the MPUC.